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CESR/CEBS Call for Evidence on Commodities (published 18th January 2008)

This evidence represents the views jointly held by the members of ISDA, the FOA and EFET. These organizations have been cooperating as part of the 'Commodity Derivatives Working Group' (CDWG), with the aim of drafting this joint response. This working group, together with the Commodity Firms Regulatory Capital Working Group (CFRC WG), which was set up to discuss the prudential treatment of commodity firms in the EU, provides an international industry platform for discussing the regulatory treatment of commodities and commodity firms active in the EU. The members of the association working groups are mainly risk officers, compliance officers, and lawyers from major commodity firms active in the EU, with expertise in the field of credit, market or operational risk.

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

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

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

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

Background

The CDWG starts from the premise that the conventional arguments for regulatory intervention in the financial sector - to protect clients or to mitigate systemic risks – do not apply to commodity firms. The arguments made for regulating the financial sector are of little relevance to commodity firms who participate in wholesale markets and trade in commodity and other non-financial derivatives with wholesale market participants who should be in a position to assess the risks inherent in the transactions they enter into. The commodity firms they deal with do not take deposits from the public. Nor is there any protection scheme or lender of last resort providing a safety net against failure which needs the protection of a regulatory capital regime. Indeed, imposing a regulatory capital regime risks creating an impression that there is an implicit safety net which itself can give rise to moral hazard. Furthermore there is very little evidence that the failure of a commodity firm poses any financial systemic risk. These commodity firms do not have the unique balance sheet structure of banks or the pivotal role that banks have in the payments system, which could serve as a means to transmit the consequences of a collapse into other market segments. Indeed, in markets such as power markets, a generator or producer that becomes insolvent is likely to continue to operate, and to fulfil its core supply obligations, under protection from its creditors, thus further weakening any possible link between firm default and systemic consequences.

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

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

We therefore welcome this opportunity to contribute to the advice the EU Commission has requested from CESR and CEBS on certain issues concerning revision of the provisions of Directive 2004/39/EC (MIFID) and Directive 2006/49/EC (CAD) concerning the regulatory treatment of firms that provide investment services in relation to commodity and exotic derivatives. We understand the Commission is keen to gather adequate technical information to be able to complete its report under the relevant articles in the Directives[1].

In responding to this call for evidence we have set out our core concerns in the letter, in the Executive Summary, which prefaces the first appendix, where we present our more detailed comments and answers to the questions from the call for evidence. In the second and third appendices we outline the rationale for, and the detail of, the "Alternative Approach" which we consider to be one of the appropriate regulatory policy options that should be discussed.

[1] Article 65(3)(a), (b), and (d) of Directive 2004/39 EC and Article 48(2) of Directive 2006/49/EC (the Report)

Executive summary

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

- Retention of an exemption from MIFID for own account trading between professional investors. In this context, the definition of ‘professional’ would need to be revisited, with a view to adapting it to the realities of the commodities market where many professional participants in these markets would currently fall outside the scope of the current MIFID classification. The CDWG believes that the investor protection concerns built into MIFID conduct of business rules are not pertinent in markets which are sophisticated and wholesale in nature, with no direct retail involvement.

- Application of an ‘appropriate’ licensing regime for activities of commodity firms other than own account trading, such as investment services and portfolio management.

- An ‘appropriate’ capital regime (“the Alternative Approach”), based primarily on internal risk management models and disclosure (rather than Pillar I minimum capital requirements), applying to firms’ activities falling within the scope of the ‘appropriate’ licensing regime mentioned above. The CDWG feels that it is particularly important to emphasise the major concerns that commodity firms have about the potential scale of capital requirements applied to them in event of a MIFID licensing requirement, whatever the limits of the final MIFID regime. We believe the Alternative Approach should be considered as the minimum standard for commodities firms where Pillar 1 capital requirements are considered disproportionate to the risks and where the costs are likely to significantly outweigh the regulatory benefits. Members of the CFRC working group are considering conducting a Pillar 1 Impact Study and we would hope to share with CESR/CEBS and the EU Commission the output from any such initiative later in the year. A disproportionate capital regime for commodity firms will have a disastrous effect on commodities markets.

- The MIFID and CAD were not designed with the commodities sector in mind and therefore the CDWG believes that any conduct of business or prudential rules should be appropriate to the nature of the commodities market. By way of illustration, some provisions which will apply to MIFID firms (for example best execution and client classification) will need adapting to reflect the wholesale nature of the market.

- The retained exemption for own account trading between professional investors should be applied in a harmonized way throughout the EU. A focus on delivering this harmonized implementation will benefit the EU single market, delivering economies of scale for market participants, greater competition, and lower commodity prices for end-users.

- No change to the current definitions of commodity derivatives.

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

The CDWG believes that questions of market conduct should be dealt with under the Market Abuse Directive. It is currently reviewing the Market Abuse Directive to assess its appropriateness for commodities markets.

We also believe that the commodities review should examine the scope for alleviating MIFID and CRD regulatory burdens placed on credit institutions and investment firms active in these markets, which have also proved to be important liquidity providers, and will play a key role in the deepening and development of commodities markets in the coming years.

We would be happy to discuss any of these comments further and or hear your views on our response, and to arrange this please contact either Ed Duncan (at ISDA), Roger Cogan (at ISDA in Brussels) or Simon Andrews (at the FOA).

Yours sincerely,

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Head of Risk and Reporting
ISDA

Roger Cogan
Director of European Policy
ISDA

Simon Andrews
Prudential Regulation Manager
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Appendix 1

Specific questions

1) Does the present regulatory and market situation for firms providing investment services relating to commodity derivatives and exotic derivatives give rise to market failure in the relevant markets, in particular by?

i) Hampering the aims of market regulation, e.g. ensuring investor protection and market integrity via principles and rules relating to organisational requirements and conduct of business of firms, or designed to ensure fair and orderly trading with optimal levels of transparency, or

ii) Hampering the aims of prudential regulation, e.g. stability of the financial system and provision of sufficient protection for depositors?

We believe that the EU Commodity markets are functioning well, and that there is little evidence of widespread market failure. We are not aware of, for example, any evidence of market failure concerning transparency in the commodities market, nor regarding market abuse in commodities markets. We note that the review of the Market Abuse Directive and the European Commission review (as part of the third Energy Package proposals) of transparency in electricity and gas markets, conducted in cooperation with CESR and ERGEG will look more specifically at these issues and we plan to provide additional work in response to the forthcoming CESR – ERGEG consultation.

The CDWG believes that the existing exemptions from MIFID and CAD for commodities firms were appropriate and have helped to reduce the risk of market failure in the sector. Subjecting commodity firms to full conduct of business and the Basel II minimum regulatory capital requirements would have caused many firms to seriously re assess the costs and benefits of doing business in Europe's commodities markets.

We are aware, however, that the application of these exemptions and some other aspects of MIFID have not been consistent throughout the European Union. In particular we note that some member states adopt a definition of regulated financial instruments which is broader than required by MIFID. Also, the exemptions contemplated by article 2 of MIFID have not been fully implemented by all Member States and we note that others have imposed national regulatory regimes on firms that take advantage of the exemptions, including as to whether to allow firms to take advantage of the CAD exemptions. Then, even when a Member State appears to have "copied out" MIFID and the MIFID or CAD exemptions in full, there are differing interpretations of how the exemptions apply in practice.

The differences in the regulatory treatment of commodity firms cause significant challenges for firms conducting cross-border business. The effect of authorisation requirements is generally to compel firms to carry on regulated activities in a separate subsidiary (at least where the authorisation carries significant additional requirements, such as capital or business conduct rules). The effect of differential implementation across member states is to increase the amount of business that has to be done in the separate subsidiary. It has led some groups to opt to use regulated entities to conduct some aspects of their business, increasing operational complexity and the costs of doing business.

In addition, the temporary nature of the CAD exemptions and the review of the MIFID exemptions have created legal uncertainty as to the future shape of the regime (especially because of the risk that any EU legislation implementing a new regime will not be adopted before the CAD exemptions expire).

We consider an optimal regulatory framework for commodity firms would ensure that there is a common European approach to the key elements of regulation of these markets. Even regulated banks and investment firms can have issues doing cross-border business in the EU to the extent that member states adopt super-equivalent definitions of what constitutes a regulated financial instrument which can impede their ability to rely on their EU passport. EU licensing requirements may impede the ability of non-EU group companies that do not need to be regulated in their home state, to enter into transactions in MIFID regulated instruments with EU based counterparties.

Concerning paragraph ii) of question 1, the exemptions from capital requirements for commodity firms benefiting from the exemptions in article 2(1)(i) and (k) are, we feel entirely appropriate, given the lack of systemic risk associated with commodity firms' trading activities. In our view, application of Pillar I capital requirements to these firms would not only be disproportionate and unnecessary, it could also reduce participation in these markets, undermining the efficiency of pricing, and drive commodity firms that would remain in these markets to subsidiarize their commodity trading activity, further increasing complexity and risk. Serious consideration needs to be given to unintended consequences resulting from excessive levels of regulation.

2) Do the differences in regulatory treatment between categories of firms that provide investment services in relation to commodity and exotic derivatives and across Member States give rise to a regulatory failure, by:

i) Creating significant competitive distortions;

ii) Significantly impairing the free movement of services between Member States; or

iii) Encouraging market participants to engage in a significant degree of regulatory arbitrage?

The CDWG does not consider that the exemptions in MIFID (and CAD) for certain categories of firms have given rise to significant competitive distortions. It has allowed firms to continue to participate and provide liquidity in the market that might otherwise have been forced to limit their participation. In particular, the fact that the exemptions (where adopted) also apply to non-EU entities has made it easier for both EU and non-EU groups to organise their activities in global markets in ways that are more efficient, enhancing competition within the single market.

On the other hand, while MIFID seems to have led to a greater commonality of approach to regulation, the disparities of treatment referred to above have created challenges for commodity firms.

In addition, it is anomalous that some of the existing exemptions are unavailable to entities that are part of a group whose main business is banking or investment services but which otherwise meet the requirements for the exemption. This produces significant distortions, e.g. where a banking or investment firm group makes a direct or indirect private equity or other principal investment in an entity which hitherto had been able to rely on one of these exemptions (for example, where such a group takes a stake in a power station which has trading activities). In any

event, the appropriate way of addressing the possible risks that such stakes present to the regulated entities in the group is through the application of the accepted principles of consolidated supervision, rather than requiring an entity to be licensed even though, if it were unconnected to such a group, it would be able to continue to rely on the exemption.

However, we recognise that some firms falling within the exemption may wish to choose to be regulated as MIFID investment firms. Firms may wish to opt in to regulation if they perceive that regulated status is significant to its particular counterparties. Alternatively, they may need to elect for regulation to the extent that favourable third country regimes (such as the CFTC's Part 30 regime in the US) are only available to firms that are regulated in their home state. Similarly, those specialised commodity firms that are regulated as MIFID firms should be able to choose whether or not to apply the alternative prudential regime outlined in Appendix 2.

The CDWG also questions the assumption made in paragraph iii) of question 2 that regulatory arbitrage leads to regulatory failure. We believe, rather, that over-regulation in particular Member States of the wholesale trading activities of commodity firms in the years prior to MIFID has logically forced commodity firms to seek out jurisdictions where regulatory frameworks are more conducive to deeper, more liquid commodities markets. It is these more enlightened jurisdictions which have seen the greatest advances in the development of their commodities markets.

3) To the extent that market or regulatory failures are identified, can it be anticipated that such failures would be eradicated as a natural consequence of market evolution in the short to medium term?

No. However, we do believe the commodities markets have evolved to a level of sophistication where risks are measured, monitored and managed. We believe that commodity markets left unfettered by excessive regulation will continue to grow in importance and size. Deeper and more developed commodities markets, continuing to effectively mitigate and manage the risks, will improve liquidity and efficiency in pricing.

We do not believe the market failure analysis conducted to date provides a convincing case for extending regulation in relation to conduct of business or investor protection. We believe the lack of direct retail participation in these markets is a key factor in reviewing the various policy options being considered, and underline that we are only calling for the retention of exemptions for firms whose main business is own account trading with professional investors under the MIFID.

4) Based on the response to questions 1 to 3 above and on their initial advice, do CESR and CEBS consider that the MIFID and CAD treatment of firms providing investment services relating to commodity derivatives and exotic derivatives continue to support the intended aims of market and prudential regulation? Please consider at a minimum the following aspects:

a) the application of the CAD large exposures and free deliveries treatment to commodities related transactions in the light of the commodities market practices in particular, in light of the shortcomings set out in Part C of CEBS' second advice ?

b) the method for calculating capital requirements for commodities risk set out in Annex IV of Directive 2006/49/EC in particular, in light of the shortcomings set out in Part C of CEBS' second advice?

c) the requirements for the use of internal models to calculate the capital requirements for commodities risk according to Annex V of Directive 2006/49/EC in particular, in light of the shortcomings set out in Part C of CEBS' second advice?

We welcome the EU Commission's focus on the suitability of the MIFID and CAD treatment of firms, and whether they can still achieve the intended aims of market and prudential regulation in the light of the shortcomings set out in Part C of CEBS' second advice. We consider the section entitled "*Shortcomings of the prudential requirements*" in Part C of this advice (paragraphs 147 – 163) as a fair reflection of the comments submitted by industry participants as part of the public consultation on an earlier draft of the CEBS advice (published in July 2007). In particular we highlighted the challenges involved in managing seasonality, how natural cycles which affect prices will likely lead to distortions in proposed regulatory capital calculations (e.g. harvest time for agricultural crops, winter time for gas, etc) and, more specifically, how requiring the use of spot prices for risk management purposes would be inappropriate for commodities where storage is an issue (power, and to a certain extent gas).

Large Exposures:

For specialist commodity firms large exposures frequently result from operations taken by trading entities on behalf of other group companies. As intra-group balances these exposures do not represent a liability on the part of the trading entity. These balances should not require an additional capital charge. Long dated gas contracts can also give rise to large exposures as power suppliers can only account for the actual delivery quantities at month end (due to non-storability) and this creates the large exposures. More generally, large exposures can arise more frequently in the commodities sector as a result of firms providing services and charging for them at a later date. In such circumstances, the unmodified application of the CRD serves to unnecessarily restrict the amount of free capital within firms and so reduce liquidity within already illiquid markets, without furthering the objectives of the original legislation. We therefore do not believe that the Large Exposures regime is appropriate for commodity firms.

Free Deliveries:

The CEBS report comments on the impracticality of the requirement that free deliveries be deducted from own funds from the 5th business day after the contractual due date with regard to market practice within several commodity markets. The requirement is based on the assumption that a 5 day delay between the contractual due date and payment represents a strong risk of default on the part of the customer, and hence imposes a significantly increased charge to cover that risk. It might be possible to consider instead a scaling factor that would depend on the number of days past the contractual due date that the payment is overdue.

Capital calculations:

The CDWG has commented on a number of specific issues with capital calculation methods set out in the Directive in the past. These issues are numerous and varied, and stem primarily from a failure of the directive to consider the ways in which commodity derivative markets based on a physical underlying necessarily differ from financial derivative markets with no physical underlying, and indeed amongst themselves. The attempt to produce a simple, one-size-fits-all solution necessarily fails to accurately fit the needs of diverse markets.

In the past we have highlighted the difficulties of relying on spot prices for regulating those commodities that suffer from relatively high short term volatility. Again this can be a feature of non storable commodities, where fluctuations on the demand side together with disturbances on the supply side result in price spikes in the short term. These effects even-out over longer periods of time, but make it difficult to rely on spot prices for capital calculations. It is also worth remembering that where spot and forward prices are highly correlated in most financial markets for some commodities there is no correlation, with different supply and demand conditions affecting the different prices. And yet the existing maturity ladder approach in Annex IV of the capital directive requires a market risk charge based on spot prices for all commodity positions. This would result in capital numbers, particularly for non storable commodities, that do not accurately reflect the risks and would be in practice highly volatile. Furthermore because the maturity ladder buckets are not calibrated for term prices they do not allow firms to accurately net positions which carry a reduced net level of risk over the longer term due to brief fluctuations in daily spot prices[2].

Use of internal models:

Across the spectrum of commodity firms, considering both the different markets and the differing size of market participants, the use of sophisticated internal models varies. For those firms which make extensive internal use of VaR models, a key concern is the cost of securing regulatory approval for those models with a view to using them for advanced capital calculations. Particular costs arise from the need to modify models purely for regulatory purposes, with the implication being that firms would have to maintain additional model sets. For example, where firms are required to exclude from calculations trades undertaken for group hedging purposes, and determining which trades are eligible for exclusion becomes an onerous and costly process. Costs also arise from the need to refine existing models to accommodate the higher thresholds demanded by the Directive. Models previously intended for internal use frequently lack sufficient historical loss data to meet the specified thresholds.

There are also difficulties in applying regulatory definitions for certain model parameters, e.g. for calculating EPE, which have been defined with financial products in mind. The requirements for calculating EPE do not consider the seasonal structure of prices which are predominant for gas and power, and this can lead to the potential for excess capital charges. As a result modelling for commodities with seasonal pricing fluctuations in some respects can be more demanding and costly than modelling for financial instruments. There is a fair chance that with the Current Exposure Method (CEM) resulting in lower and less volatile capital charges, there would be no incentive to use an Internal Models Methodology (IMM).

Liquidity risk:

A matter that is not reflected adequately in the regulatory rules but can pose a significant risk to the existence of some commodities traders is the risk of a rating downgrade (Note that not all traders or their clients have external ratings). In such circumstances many rated firms (often trading entities use the rating of their parents) have rating triggers in their master agreements and are exposed in the case of a downgrade below investment grade (e.g. below BBB- for S&P) to additional claims for securities or cash. A firm can fall in to trouble if these claims cannot be met in a relatively short time frame (e.g. this happened to US energy traders in 2001 and 2002). The

[2] CEBS report (10th Oct 2007), paragraph 155 "*Perceived shortcomings of the standard method for market risk for power [the maturity ladder approach (MLA)]*"

current regulation for liquidity risk does not cover this risk. However these risks would be captured by the "Alternative Approach" (Appendix 3, 4.7 "Liquidity risk management"), which includes a set of guiding principles for firms and regulators to follow to ensure that liquidity risk is adequately measured, managed, and reported.

d) the obligation to uphold integrity of markets and to comply with the organisational requirements and conduct of business obligations incumbent upon investment firms as per MiFID;

The CDWG considers that MIFID's conduct of business obligations do not fully recognise the wholesale nature of the commodities market. We believe that commodity firms should be able to benefit from an exemption from MIFID for own account trading with other professional wholesale counterparties, on this basis.

However, the restrictive rules as to when a regulated firm can treat various kinds of counterparty as professional clients or eligible counterparties for the purposes of MIFID are a significant barrier in this regard. We consider that there should be an expanded definition of professional client and eligible counterparty that applies in relation to business in commodity and other non-financial derivatives. The expanded definition should be used for the purposes of defining when firms benefit from the proposed new exemption discussed below for firms trading on own account with professional counterparties and, for those firms that are subject to authorisation, to define the extent of their duties under the conduct of business regime. The definitions should be expanded by:

- Allowing firms to treat undertakings as professional clients where the undertaking is part of a group of undertakings which meets the existing size thresholds on a consolidated basis.

- Including companies with securities listed in Europe or under comparable regimes elsewhere (and their subsidiaries) as professional clients and eligible counterparties, regardless of size.

- In relation to commodity and non-financial derivatives, including undertakings whose main business is trading in commodities or the underlying subject matter of any such instrument or that are producers or professional users of commodities or such underlying subject matter.

We remind CESR and CEBS that direct retail participation in commodities markets is very low, and that where retail investors do invest in commodities markets it is through professional intermediaries. Thus, core conduct of business concerns are not pertinent to these sophisticated, wholesale markets.

We believe, however that commodity firms should be able to choose to be regulated under the MIFID if they consider the benefits outweigh the costs. As mentioned above, they also may wish to opt in to regulation if they perceive that regulated status is significant for their counterparties or to benefit from favourable third country regimes that are only available to firms that are regulated in their home state.

We wish to underline that we believe that retail participants in commodities markets should always be provided with a strong level of protection under regulation. In this context, we refer

you to the UK FSA guidance on MIFID and the wording on 'Elective Professionals', which we believe is useful, in this context:

> *"the firm undertakes an adequate assessment of the expertise, experience and knowledge of the client that gives reasonable assurance, in light of the nature of the transactions or services envisaged, that the client is capable of making his own investment decisions and understanding the risks involved (the "qualitative test");"*[3]

Finally, we consider that the appropriate place to address market integrity issues for these markets is through the Market Abuse Directive (and through the regulation of regulated markets and MTFs). This should provide adequate protection of market integrity. However, we are reviewing the appropriateness of the Market Abuse Directive for these markets.

e) the criteria for determining which instruments are to be treated as having the characteristics of other derivative financial instruments, or as being for commercial purposes, or which fall within Section C(10) of Annex I to MiFID if the other criteria set out in that Section are satisfied in relation to them (c.f. Article 40(2) of the MiFID implementing Regulation);

We do not advocate changing the definition of "financial instrument". Instead, we recommend taking steps to ensure that all member states adopt a common perimeter to their licensing of derivatives transactions.

In some countries, it will be important to ensure that rules allowing netting are applied more broadly so as to be available in relation to transactions that are not financial instruments within the scope of MIFID. However, the limitations on netting in some countries are not a reason for expanding the scope of the MIFID licensing requirements.

5) Does the analysis above vary significantly depending on the type of entity providing the investment services or the underlying of the financial instrument? In particular does it differ for investment firms engaged in energy supply?

At this stage we do not consider that it is desirable to make artificial distinctions between various categories of commodity and exotic derivatives.

6) In view of the above and their initial advice, what are the views of CESR and CEBS with respect to the following options or combination of options relating to the exemptions:

a) Issuing clarifying guidance as to the meaning of the various exemptions, and if so, with what content;

b) Maintaining the current scope and nature of exemptions from the relevant CAD and MiFID requirements for firms in the commodities sector: i.e., making the CAD exemption in Article 48(1) permanent, and maintaining the MiFID exemptions in Articles 2(1)(i) and (k) in place;

c) Studying the desirability of modifying the range of firms benefiting from exemptions and/or modifying the scope of the exemptions to cover more or fewer of the different requirements of the CAD (i.e. capital requirements, large exposures, internal governance and risk management, disclosures etc.) or of the MiFID, and to apply the exemptions differently to certain commodities?

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[3] http://www.fsa.gov.uk/pubs/other/mifid_classification.pdf

i) Defining the criteria for determining when an activity is to be considered as ancillary to the main business on a group level as well as for determining when an activity is provided in an incidental manner (Article 2(3) MiFID);
ii) Defining an appropriate regime for the prudential supervision of investment firms whose main business consists exclusively of the provision of investment services or activities in relation to commodity or exotic derivatives contracts (Article 48(2)(a) CAD);
iii) Create a further category of investment firms whose main business consists exclusively of the provision of investment services or activities in relation to the financial instruments in Section C5, 6, 7, 9 and 10 of Annex I of MiFID relating to energy supplies(Article 48(2)(b) CAD);

d) Studying the desirability of making the existing exemptions optional for individual firms; i.e., firms in principle exempted that wanted the MiFID passport could opt-in to the European regime by accepting MiFID and CAD regulation; while firms which remained exempt would remain within any applicable national regimes;

e) Studying the desirability of making the existing or proposed exemptions mandatory, i.e. pre-empting Member States from regulating exempt firms under national rules relating to capital adequacy, organisational requirements and/or operating conditions;

f) Removing some or all of the exemptions entirely?

The CDWG considers that the second limb of article 2(1)(i)[4] and article 2(1)(k) should be replaced by a new single exemption covering persons (other than operators of an MTF or of a regulated market) whose main business consists of dealing on own account with professional counterparties in relation to commodities and/or commodity derivatives or other non-financial derivatives contracts covered by MIFID (under points 5, 6, 7, 9, and 10 Section C, Annex I).

This new exemption should apply to such an entity's activities when dealing on own account in those derivatives contracts with professional counterparties, within the expanded definition described above. The exemption should not be available to an entity if it seeks to deal with retail investors.

The new exemption should be available to firms when dealing for their own account in those derivatives contracts, including when they deal for their own account by executing client orders. The availability of the exemption should not depend on the technicalities of exactly how the firm transacts its own account business with professional counterparties.

The new exemption should avoid referring to “firms whose main business consists exclusively of dealing on own account”. The new exemption should be structured in a way that is clear and less open to misinterpretation. We think it should be possible to combine the new exemption with other exemptions, such as article 2(1)(b) and the first limb of article 2(1)(i). For example, like any

[4] Article 2(1)(i) has two limbs. The first limb provides an exemption from MIFID for persons dealing on own account in financial instruments (of all kinds) provided that this is an ancillary activity to their main business, when considered on a group basis. The second limb provides a separate exemption for persons providing investment services in commodity derivatives and other non-financial derivatives covered by MIFID (under section C10, Annex I) to the clients of their main business, when considered on a group basis. Under both limbs, the exemption does not apply if the group's main business is providing investment or banking services.

other business, an entity relying on the new exemption may also need to hedge its interest rate or foreign exchange by entering into interest rate or foreign exchange derivatives.

As discussed above, the new exemption should be available to all firms regardless of the main business of their group of companies. Member states should be required to implement this new exemption into their national law. There should be a common approach across Europe as to when this exemption is available. Firms covered by the new exemption would be exempt from capital requirements under the CAD.

However, as discussed above, firms that are eligible for the new exemption should be able to elect to be regulated under MIFID instead (i.e. to be able to opt in to regulation). Firms that are eligible for the new the exemption and elect to be regulated under MIFID and other MIFID regulated firms whose main business is providing investment services or activities in relation to commodities and/or commodity and exotic other non-financial derivatives should be able to choose to apply the alternative approach to prudential supervision outlined in Appendix 3 (and the existing CAD exemptions would no longer apply).

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

Again, some CDWG members consider that the new exemption for firms whose main business is dealing on own account in commodities and/or commodity and other non-financial derivatives should also cover a firm that provides other investment services, such as investment advice, in relation to commodity and other non-financial derivatives, where those services are provided as an ancillary activity to the firms' main business. In particular, these firms are concerned that the absence of such an extended definition could undermine their ability to continue to conduct business without inappropriate and unduly burdensome authorisation requirements. For example, there are concerns that the unclear boundary between providing tailored information and giving investment advice could affect firms' ability to rely on the new exemption. Similarly, some joint venture companies that provide services to their shareholders are concerned about the results of the removal of the exemptions for services provided as an ancillary activities, especially given that article 2(1)(b) only covers services to a parent undertaking, not to shareholders holding other levels of participation in the joint venture.

Appendix 2

1. Explaining the Alternative Approach

The Commodity Firms Regulatory Capital Working Group (CFRC) 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, as recognised by CEBS[5] and the FSA[6] renders a minimum capital charge an inappropriate method of regulating specialist commodity firms.

Regulatory capital also exists for the purpose of protecting customers without the market experience to protect their own interests. Recent market analysis shows that participants in commodity markets consist almost exclusively of a combination of producer/suppliers from the physical market and experienced banks, investment funds, hedge funds and similar, all of whom are presumed to have sufficient market expertise to remove much of the need for additional protection in the form of regulatory capital.

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 CFRC proposes an approach that removes the need to hold minimum regulatory capital in favour of minimum financial resources, 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:

- the need for computing and holding a minimum level of regulatory capital is abandoned in favour of requirement to ensure an appropriate level of financial resources;
- the approach combines existing and proven risk management practices from a number of EU jurisdictions to create a bespoke regime, rather than simply copying what the banks do; and
- the approach incorporates Pillar 3 and IFRS disclosure requirements and develops requirements which are relevant to the commodity industry.

[5] Response to the second part of the European Commission's August 2006 call for advice, in which CEBS assess the prudential risks arising from the conduct of commodities business (paragraph 12).
[6] UK discussion paper on the Commission's review of the financial regulatory framework for commodity and exotic derivatives (Dec 2007, paragraph 4.16).

2 Introduction

The Commodity Firms Regulatory Capital Working Group (CFRC) is a joint task force set up by ISDA[7], EFET[8] and the FOA[9] to discuss the prudential treatment of commodity firms in the EU. The CFRC comprises 21 commodity firms active in the European energy and metal markets.

The arguments made in this paper build upon the considerations and concepts presented in the letter from the CFRC to the Commission dated 27th January 2006. In that letter, we queried the rationale for the application of prudential regulation to commodity market participants. We are seeking below to provide CEBS/CESR with a detailed analysis of why we feel that the regulation of commodity firms should not rest upon minimum capital requirements, but rather minimum capital resources combined with a focus on good risk management practices and disclosure. We would be pleased to discuss our assessment with CEBS/CESR and the Commission and local regulators.

The CFRC 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, in the event that the current review concludes that some form of prudential regime is necessary, while we argue that trading entities embedded within commodities firms should not be regulated via regulatory capital[10], we believe that entities covered by new or amended legislation should:

- be subject to appropriate regulation, including the need to demonstrate adequate systems and controls; and
- 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.

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7 ISDA represents participants in the privately negotiated derivatives industry. ISDA was chartered in 1985, and today has over 800 member institutions from 56 countries.

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

9 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.

10 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.

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 paper outlines the conceptual underpinnings of the Alternative Approach put forward by the CFRC. It is intended to provide regulators and other interested parties with a review of the problems, both conceptual and practical, with a prudential regime for specialist commodity firms which is based on the concept of regulatory capital. At the same time, the CFRC hopes to provide a more detailed explanation of certain aspects of the proposed Alternative Approach, based on feedback received from regulators to date.

The argument against the imposition of a Pillar I capital calculation on commodity market participants and the corresponding elimination of capital add-ons in Pillar II in favour of a combination of adequate financial resources and a robust risk control framework is based on two broad principles:

- 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
- Forcing commodity market participants to meet banking style capital requirements will likely drive adverse changes within the market and increase risk.

3 Is regulatory capital a *de facto* requirement of prudential 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. The same principles inform the Alternative Approach.

Beyond even the above points, it is reasonable to consider whether regulatory capital is even an effective means of meeting the objectives of prudential regulation when applied to commodity firms as opposed to banks.

The capital structure of banks and 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 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.

4 Is cross-sectoral regulatory convergence always desirable?

Calls continue to be made by some parties for unamended application of the CRD to commodity firms on the basis that it is essential for the promotion of a “level playing field” without adequately defining the term or justifying why such a state is necessarily desirable. It is clear that some parties involved in the ongoing investigation into the commodities markets believe that a level playing field can only be achieved if all companies in a given market must follow the same rules and regulations.

The CFRC strongly believes that this position is unsupportable. Given the acknowledged differences in risk posed by commodity firms in terms of both the level of systemic risk to the financial system and risk to retail investors, the continued insistence of some respondents that commodities firms should be subject to the same regulation as banks and ISD investment firms is contrary to the principles of Basel II, that firms able to demonstrate reduced levels of risk and/or greater risk management techniques should be rewarded with a reduced capital burden.

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

A 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.

More recently, we draw attention to the comment in the HM Treasury / FSA response to the Commission’s Call for Evidence[11] that:

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

[11] HM Treasury/FSA response paper dated 30 April 2007

The CFRC 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.

5 The purpose of regulatory capital

Regulatory capital is primarily intended to meet two distinct objectives:

- Protect the financial system from the systemic implications of a significant market failure; and

- Protect depositors and investors, in particular those lacking the market experience to protect themselves.

To the extent that prudential regulation is applied to banks and investment firms these objectives can be met through the application of an effective capital regime, yet the nature of the commodity markets and of their participants is such that these aims are themselves insufficient to justify the use of the same regulatory capital regime by regulators.

The CFRC strongly believes that these two key objectives of regulatory capital are not applicable to commodity markets to the same degree as they are to other markets. To the extent that some residual systemic risk and need for depositor protection exists, that can be addressed by ensuring that firms maintain an adequate level of financial resources (see below).

5.1 Significantly reduced levels systemic risk in commodity markets

The CEBS response to the second part of the European Commission's August 2006 call for advice, in which CEBS assess the prudential risks arising from the conduct of commodities business, notes[12] that "*From a prudential perspective systemic risk is the paramount concern*", and goes on to conclude that "*In the commodities case studies examined in this report, systemic concerns were limited and contained*".

The joint paper published by HM Treasury and the FSA in December 2007 entitled '*UK discussion paper on the Commission's review of the financial regulatory framework for commodity exotic derivatives*' similarly concludes that:

> "*Although connections do appear to exist between specialist commodity derivative firms and the wider financial markets, systemic risks generated by these firms appear to be generally lower relative to systemic risks generated by financial firms. This suggests that the negative externalities traditionally addressed by prudential regulation are less marked for commodity firms than for commercial firms.*"[13]

In short, the failure of a large bank or other financial institution presents a systemic risk to the financial system. The same degree of risk does not apply to the failure of a specialist commodity firm for a number of reasons.

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

[12] Executive summary, paragraph 12.
[13] Paragraph 4.16.

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 illustrates the lack of systemic impact previously mentioned.

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.

It is important to note that the systemic risk addressed by prudential regulation is specifically risk to the financial system and not the potential for the failure of a firm to disrupt the market in the underlying commodity. While failure of a market maker in a given commodity would reduce liquidity within that market, 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.

5.2 Limited retail involvement in commodity markets

The CEBS response to the second part of the European Commission's August 2006 call for advice, in which CEBS assess the prudential risks arising from the conduct of commodities business, notes[14] that:

> *"In most commodity markets there is very little direct private client participation or instances of smaller, less sophisticated customers acting as direct counterparties to the main market participants."*

[14] CEBS response to the second part of the European Commission's August 2006 call for advice (Paragraph 95)

Only three instances of retail customer contact were noted in the industry responses used to compile the report, one in the base metals market and two in precious metals. Within those markets the CFRC, in conjunction with the Commodity Derivatives Working Group (CDWG), is already arguing for a reconsideration of customer classifications as existing classifications. As the joint HM Treasury and FSA discussion paper published in December 2007 observes[15]:

> *"Clients can request to be treated as professional if they have conducted at least 10 transactions in each of the last 4 quarters. This threshold does not take into account that quite often commodity derivative market participants engage only in a small number of transactions, but these are large scale transactions; and*
>
> *"…the size threshold [for professional market participants] is defined on a single entity basis as opposed to a definition on a group basis. This can create problems … On a stand alone basis, these companies do not qualify as a professional market participant. However, on a group basis, the size threshold would easily be met."*

Given the accepted paucity of retail clients directly active within commodity markets, and the contentious nature of some of the retail classifications, the CFRC suggests that the need for investor protection in commodity markets is significantly less than that for other markets. In direct consequence, any capital treatment which imposes proportional capital charges on commodity firms with the intent of protecting investors is unnecessary and excessive.

6 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 further believes that the imposition of a Pillar 1 capital charge on commodity firms would have negative consequences for the market as a whole.

6.1 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, 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 noncommercial 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.

[15] HM Treasury and FSA discussion paper (Paragraph 6.16).

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

6.2 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.

6.3 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 that the Alternative Approach strikes an appropriate balance without undermining the public policy agenda of financial regulation.

7 Methodology

In order to develop the Alternative Approach, the CFRC 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 conducted a survey of selected members to ascertain current risk management practices and related disclosure.

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.

The CFRC has reviewed existing methods used to ensure capital adequacy within firms. We present the concept of capital adequacy as an alternative to regulatory capital below and invite further discussion with regulators on this aspect of our proposal.

7.1 Risk management

We have already seen the arguments in favour of a regime which acknowledges and promotes robust risk management practices.

The risk management proposals of the Alternative Approach have been prepared with reference to several papers published by the Basel committee, as well as BaFin and the FSA. These views were then tempered by the consideration of commodity market specific requirements. The full list of contributing sources is as follows:

- 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; and
- Risk Management Guidelines for Derivatives, Basel Committee on Banking Supervision, July 1994.

7.2 Adequate financial resources

Maintaining adequate financial resources is necessary for any business, and the requirement to do so is recognised by many regulators[16].

As a matter of course, a well managed firm must be aware of its own financial resources and measure them against the risk appetite of the business, and this is the fundamental concept underlying Pillar 2 of the CRD. The Alternative Approach applies the same basic principles and requires firms to undertake a comprehensive risk management and capital adequacy review.

What constitutes adequate financial resources will vary from firm to firm as a function of the nature and scale of the business, together with the risk appetite and risk management systems of the firm. The CFRC does not therefore propose specific limits on financial resources that would apply to a firm adopting the Alternative Approach, instead the individual firm must justify the composition and extent of the financial resources that it believes to be adequate, potentially, but not necessarily, with reference to other regulations.

A breakdown of financial resources would form a part of the annual report made by firms adopting the Alternative Approach, much as full CRD firms must assess their level of capital in the ICAAP.

7.3 Disclosure

The CFRC recognises disclosure under Pillar 3 of the CRD as a sound means of encouraging responsible behaviour within the market. However, to the extent that the Alternative Approach

[16] For example, the FSA's Principle 4 on Financial Prudence states that "*a firm must maintain adequate financial resources*".

deviates from the CRD, it is necessary to reconsider the specifics of the Pillar 3 disclosure requirements.

The proposed disclosure framework is draw from consideration of the same sources as the risk management requirements referenced above.

7.4 Scope and consequences of non-compliance

The full anticipated scope of the Alternative Approach is outlined in the accompanying proposal paper, but that scope incorporates two significant features:

- Application of the Alternative Approach for eligible commodity firms would be voluntary on the part of the firm, but subject to the approval of the regulator. Firms could opt to apply the full CRD amended for commodity markets; and

- Concurrent with the above, regulators could remove authorisation to apply the Alternative Approach from firms which were not able to demonstrate adequate risk management procedures and financial resources. Firms would then be obliged to apply the full CRD.

ISDA® FOA EFET European Federation of Energy Traders

Appendix 3

AN ALTERNATIVE APPROACH FOR THE PRUDENTIAL REGULATION OF COMMODITY FIRMS ACTIVE IN THE EEA

1 Summary

The following is a discussion outline of the proposed Alternative Approach for the prudential regulation of commodities firms.

Following the publication of the CEBS response to the Commission's Call for Advice, it is generally accepted that commodities firms do not pose the same level of systemic risk to the financial system as banks or other investment firms. The Alternative Approach therefore focuses on good risk management principles and disclosure requirements, and proposes detailed and concrete standards which are relevant for specialist commodity firms as opposed to the calculation of CRD style minimum capital requirements.

The main features of this Alternative Approach are that:

- the need for computing and holding a minimum level of regulatory capital is abandoned in favour of requirement to ensure an appropriate level of financial resources;

- the approach combines existing and proven risk management practices from a number of EU jurisdictions to create a bespoke regime, rather than simply copying what the banks do; and

- the approach incorporates Pillar 3 and IFRS disclosure requirements and develops requirements which are relevant to the commodities 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 given the similarities between the proposed regime and the existing Pillar 2 requirements for internal assessment supplemented by supervisory review. In addition, were the full CRD to apply, 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 considers a necessary, and welcome, corollary of the CRD.

2 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.

The Alternative Approach would apply to the firm's regulated financial activities as determined by MIFID, wherever those activities are located within the firm (e.g. held in a separate subsidiary, held within the main balance sheet, etc). It would be the firm's responsibility to define the perimeter of regulation within the firm's structure, under supervision of the regulator.

The individual firm should chose whether to adopt the Alternative Approach, subject to approval of the Regulator. Those firms that wish to adopt the full CRD, subject to any amendments made to reflect the practices of commodity markets, should be free to do so. Likewise, the regulator would have the right to revoke permission to apply the alternative approach for firms which fail to maintain adequate financial resource and risk management systems. Firms without regulator approval would be required to adopt the amended CRD.

The CFRC anticipates that the regulatory approval process for firms seeking to use the Alternative Approach would be akin to that for firms seeking to use internal models under Pillar 1 of the standard CRD.

3 Adequate financial resources

In addition to ensuring a robust risk control and disclosure framework (see section 4 below), firms will be required to demonstrate that they maintain an adequate level of financial resources. What constitutes adequate financial resources will vary from firm to firm as a function of the nature and scale of the business, together with the risk appetite and risk management systems of the firm.

The CFRC does not therefore propose specific limits on financial resources that would apply to a firm adopting the Alternative Approach, instead the individual firm must justify the composition and extent of the financial resources that it believes to be adequate, potentially, but not necessarily, with reference to other regulations. However, we suggest that firms would need to demonstrate that the financial resources, whatever their nature, were sufficient to cover all debts as they fell due in addition to ensuring sufficient resources to cover amounts payable in the event either of a failure in the firm's internal risk management systems or of a wider scale market event, including the failure of a significant market counterparty.

A breakdown of financial resources would form a part of the annual report made by firms adopting the Alternative Approach, much as full CRD firms must assess their level of capital in the ICAAP.

4 Standards for risk management and disclosure

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.

These proposals have been prepared 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; and
- Risk Management Guidelines for Derivatives, Basel Committee on Banking Supervision, July 1994.

4.1 Risk management framework

The following risks are associated with commodity trading activities:

- 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; and
- Liquidity risk is the risk that the firm will be unable to meet its payment obligations (e.g. 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 4.10.

4.2 Overall responsibilities of management

4.2.1 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; and

- 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.

4.2.2 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; and

- 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.

4.2.3 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.

4.3 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.

4.3.1 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.

4.3.2 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 4.4, 4.5, 4.6 and 4.7 below.

4.3.3 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.

4.3.4 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 4.9 below.

Internal audit must be advised of any significant changes or weaknesses in risk management.

4.3.5 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.

4.4 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.

4.4.1 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 back tested 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.

4.4.2 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.

4.4.3 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.

4.5 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.

4.5.1 Identifying and assessing credit risk

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

4.5.2 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.

4.5.3 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.

4.5.4 Controlling and mitigating credit risk

4.5.4.1 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.

4.5.4.2 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.

4.5.5 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.

4.6 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.

4.6.1 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.

4.6.2 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 4.6.4 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.

4.6.3 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.

4.6.4 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.

4.6.4.1 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.

4.6.4.2 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.

4.6.5 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; and

- 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.

4.6.6 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.

4.6.7 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.

4.7 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.

4.8 Stress testing

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; and

- 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.

4.9 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.

4.9.1 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.

4.9.2 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.

4.9.3 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; and
- 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; and
- 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.

4.9.4 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 a minimum of 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.

4.10 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 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; and
- Policies for hedging or mitigating risks.

4.10.1 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; and
- The approach taken for stress testing and the use made of stress test results.

4.10.2 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; and
- 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.

4.10.3 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; and
- The internal structures for governance and oversight of operational risk.

4.10.4 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; and
- The approach to stress testing.

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