



Why reform?

Overview of the new EU regulatory framework for commodity derivatives

Brussels, 9 November

DG FSMA

Please note that this presentation does not constitute binding legal advice and comes without prejudice to the position the commission may take in proceedings or on any other occasion.

Agenda

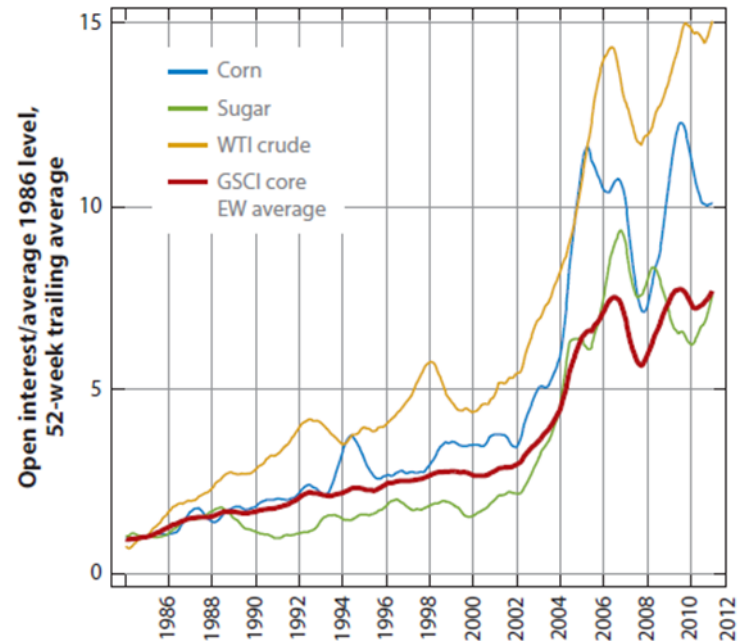
- Motivation for reform
- Post Crisis regulatory framework
 - EMIR
 - MIFID
 - BMR
 - MAR (separate presentation)

Financialisation of Commodity Markets



Figure 1

This figure plots the level of the GSCI Total Return Index as well as commodity prices for corn, crude oil, and copper, normalized to the average price in 2000. Data source: Bloomberg. Abbreviations: GSCI, Goldman Sachs Commodity Index; WTI, West Texas Intermediate.



Implications for financial market regulators

Commodity derivatives traded mostly OTC:

- *Opaque Markets*
- *Lack of transparency in price setting*
- *Lack of supervision and coordination between regulators*
- *High volatility*
- *Settlement and credit risk*

Debate at G20 on regulatory reform of financial and commodity markets

Pittsburgh G20 – Sept 2009

“...all standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest.”

“...improve the regulation, functioning and transparency of financial and commodity markets to address excessive commodity price volatility”

Commodity derivatives Regulatory Framework

Regulatory Objectives

Transparency

- Scope of instruments covered
- Trading on trading venues
- Position reporting
- Supervising large traders

Market Integrity

- Market Abuse
- Link physical and financial markets
- Position Limits
- Financial Benchmarks

Prudential

- Central Clearing
- Bilateral collateral

EMIR

G20 Commitment to Centrally Clear

Central clearing reduces systemic risk stemming from the OTC derivatives markets by:

- Breaking interconnectedness between market participants: 'domino effect'.
- Ensuring positions are collateralised and mutual guarantee funds are maintained.
- Centrally managing defaults.



EMIR Who does it affect?

Applies to all users of derivatives: Financial counterparties, (FCs) including banks, cooperatives, funds, insurers and non-financials counterparties (NFCs)

Lower requirements apply to NFCs that only use derivatives to hedge real economy needs (NFCs-)

Also introduces harmonised requirements for market infrastructures: CCPs & Trade repositories (TRs)

Key requirements - Central Clearing for OTC derivatives

- ESMA determines which products should be cleared through CCPs, via level 2 RTS (clearing obligation on certain IRS and CDS classes)
- For now Commodity derivatives are not in scope
- Financial counterparties and large NFCs (NFC+) must clear those contracts through valid EU or third country CCPs deemed equivalent

Key requirements - Risk mitigation for non-centrally cleared OTC derivatives

- FC and NFCs must put in place risk management processes to ensure legal certainty and accurate risk capture
- Further, FCs and NFCs+ must exchange collateral on a bilateral basis for trades that are not centrally cleared



MIFID

Main Commodity Measures

- Increasing the scope of commodity derivatives covered by MIFID
 - Stricter delineation between financial & physical markets, inclusion of emission allowances
- Increasing the scope of commodity traders covered by authorisation requirements
 - Capture non-financial entities acting as financial entities
- Position Limit and reporting regime to enhance transparency and to combat market abuse



Reducing Exemptions for non financial traders

- MIFID II restricts the scope of exemptions to capture non-financial companies where they act as financial ones.
- Commodity trader exemption: MIFID II does not apply to persons who:
 - Deal on **own account** including market making in commodity derivatives & emission allowances/derivatives (excluding persons who deal on account by executing client orders) OR
 - Provision **of investment services** in commodity derivatives & emission allowances/derivatives to the customers or suppliers of main business;
 - Provided that it is an **ancillary activity** to their main business when considered on a group basis; and
 - **Main business** is not the provision of investment services or banking services, or acting as a market-maker in relation to commodity derivatives
 - No high frequency algorithmic trading technique

Position limits/ management/reporting

- Main features:
 - NCAs to set net position limits that any person can hold in commodity derivatives at all times
 - A EU harmonised regime: ESMA sets methodology , as enshrined in RTS and monitors implementation
 - Position-reporting obligation by category of trader
 - Additional safeguards through position management controls by trading venues
- Objectives of position limits
 - Prevent market abuse (MAD)
 - Support orderly pricing and settlement conditions, including preventing market distorting positions

Position limits

- Contracts within scope :
 - **All exchange traded commodity derivatives**
 - **Economically equivalent OTC contracts**
- Hedging exemption:
 - **Positions held by a non-financial companies objectively measurable as reducing risks directly related to their commercial activity.**
- Limits set
 - **By contract, spot month non-spot month**
 - **At a net-basis**
- Limits imposed on "persons"
 - **Ultimate client concerned – also if exempt under MIFID**
 - **Positions are aggregated at group level**

Position reporting

- **Commitment of trader reports:**
 - **For exchange traded derivatives, trading venues to publically report weekly (aggregation) by categories of persons**
 - **For both exchange traded derivatives and OTC a complete break-down of positions held by all persons to NCAs at least daily**
- **Position reports to regulators:**
 - **Members, participants (RM, MTF) and clients (OTF) to report to the trading venues their own and end-client's position at least daily**

Benchmark Regulation- recap

- Implements international IOSCO principles
- **Scope:**
 - **Wide scope**
 - **All indices used:**
 - in financial instruments,
 - financial contracts or
 - for the performance of investment funds
- **Authorisation and supervision**
 - **Authorisation and supervision of administrators by national competent authorities**
 - **Closing the regulatory gap**

Benchmark Regulation- recap

- **Administrator Requirements**
 - Organisational, governance requirements, accountability and record retention mechanisms
 - Methodology and input data
 - Transparency
 - Monitoring of input data
- **Contributor requirements-**
 - Code of Conduct- controls on how to input data
 - Supervision for regulated entities
- **Specific Sectorial requirements**