Committee of European Banking Supervisors
CEBS

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**First part of CEBS's technical advice to the European Commission on the review of commodities business under Article 48 of Directive 2006/49/EC**

**Survey of the current prudential practices for commodities business and firms carrying out commodities business**

## Background

1. On 16 August 2006, the European Commission issued a Call for Advice (No. 6) asking CEBS to provide technical advice to assist the Commission services in carrying out a review in relation to
   a) the current prudential supervisory practices for commodities business and firms carrying out commodities business and
   b) the prudential risks that arise from the conduct of commodities business.
2. CEBS was invited to provide the survey referred to in point (a) by December 2006 and the survey referred to in point (b) by April 2007. The call for advice is posted on the CEBS website under http://www.c-ebs.org/Advice/CFA_Commodities.pdf
3. This report provides the review referred to in point a) including an analysis of the national prudential supervisory regimes currently in place in EU Member States (and some other respondents, see Annex 1). It covers the scope of the regimes and their coverage of risks and comments on the ways in which national supervisory regimes deal with firms and commodities business carried out within financial and non-financial groups. The analysis also includes an assessment of the prudential supervisory regimes in place in major third country financial services markets.

## Methodology

4. CEBS mandated the Expert Group on Capital Requirements to conduct the tasks set out in the Call for Advice. The EGCR set up a working group (Sub-group on Commodities Firms and Commodities Business – CFCB). A detailed questionnaire was launched to all CEBS's members and observers in order to obtain an up to date description of the current regimes for commodities business and firms carrying out commodities business in the EU. The questionnaire can be accessed by clicking on www.c-ebs.org. Information was also collected on the prudential supervision in three third countries (U.S., Australia and Switzerland).

5. This survey is based on the responses provided to the questionnaire by all the EU member states and three EEA members (Norway, Liechtenstein and, Iceland). Further information was provided by one of the accession countries[1]. For ease of comparison, the information has been compiled and summarised in Annexes 2 to 4.

6. Within the framework of the Joint Protocol between CESR, CEBS and CEIOPS and the 3L3 Work Programme for 2006, CEBS has informed CESR and CEIOPS about its work with regard to this Call for Advice and keeps them posted on all its work. CESR has nominated an observer for the CFCB.

7. The main findings of this survey were discussed with industry experts designated by the CEBS Consultative Panel and additional input was provided.

## Executive summary

8. The Call for Advice No. 6 is part of a larger review of the current provisions concerning commodities business and the prudential treatment of firms carrying out commodities business set out in Directive 2004/39/EC on Markets in Financial Instruments (MiFID) and the Capital Requirements Directive (CRD)[2].

9. All but five respondents stated that under their current prudential supervisory provisions banks or investment companies carrying out commodities business are subject to supervision according to the Investment Services Directive (93/22/EEC – ISD) and/or the Capital Adequacy Directive (93/6/EEC – CAD)/Banking Directive (2000/12/EC – BCD). However, these provisions were not issued with this sector particularly in mind nor do they focus specifically on commodities firms or commodities business and apply to commodities firms only in so far as they carry out activities addressed by the ISD.

10. With the transposition of the MiFID the current definition of financial instruments will be broadened and a number of firms carrying out commodities business and business activities connected with commodities which are currently outside the scope of the EU directives will become subject to supervision. This may lead to amendments to the current prudential supervisory regimes. Further changes may be caused by the transposition of the CRD.

11. Some of the respondents differentiate in their prudential requirements between the activities carried out and the underlying products. The prudential requirements implemented include initial capital requirements (varying according to the risk content of the activity), minimum capital requirements and organisational requirements.

12. The national prudential regimes address different types of risks. The focus is on firm related and product/transaction related risks (market risk, credit risk and operational risk). Only a few respondents reported explicit provisions with regard to macro prudential risk. In those cases, they generally referred to a

[1] Bulgaria

[2] Directives 2006/48/EC relating to the taking up and pursuit of the business of credit institutions (recast) and 2006/49/EC on the capital adequacy of investment firms and credit institutions (recast)

mitigation of macro prudential risk by a broad regulation of the financial services markets, exchanges and firms, including non-ISD commodity derivatives firms.

13. According to information on third country regimes available until November 2006, the US has a well-developed regulatory regime for commodity derivatives business and market participants are subject to varying levels of regulatory capital depending on the nature of the activities undertaken. The prudential regime in Australia, on the other hand, does not specifically address specialist commodity derivatives firms and focuses on prudential requirements for banks and investment firms. Switzerland has implemented regulations for exchange traded and OTC derivatives which likewise do not specifically address specialist commodity derivatives firms.

## Survey of national prudential supervisory regimes

## Introduction

14. The Call for Advice No. 6 is part of a larger review of the current provisions concerning commodities business and the prudential treatment of firms carrying out commodities business set out in Directive 2004/39/EC on Markets in Financial Instruments (MiFID) and the Capital Requirements Directive (CRD)[3].

15. Section C of Annex I to the MiFID sets out a new definition of financial instruments. In points 5, 6, 7, 9, and 10 it explicitly refers to derivatives relating to commodities, climatic variables, freight rates, emission allowances or official economic statistics such as inflation rates. This definition of financial instruments is significantly broader than the definition given in Directive 93/22/EEC on investment services in the securities field (ISD) which was replaced by the MiFID.

16. Recital 25 of the MiFID, however, states that the scope of prudential regulation should be limited to those entities which, by virtue of running a trading book on a professional basis, represent a source of counterparty risk to other market participants. Entities which deal on their own account in financial instruments, including commodities derivatives, as well as those that provide investment services in commodity derivatives to the clients of their main business on an ancillary basis to their main business should be excluded from the scope of the MiFID.

17. Art. 65 (3) of the MiFID requires the European Commission to report inter alia on the continued appropriateness of the exemption for undertakings whose main business is dealing on own account in commodity derivatives and the content and form of proportionate requirements for the authorisation and supervision of such undertakings.

18. Also, in conjunction with this review, the capital requirements for commodity dealers, including those dealers currently exempt from the requirements of the MiFID, shall be reviewed as appropriate (see Recital 21 of Directive 2006/49/EC). Art. 48 (2) and (3) of Directive 2006/49/EC therefore requires the Commission to report on -

    a) 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 derivatives or derivatives contracts set out in points 5, 6, 7, 9 and 10 of Section C of Annex I to the MiFID; and

    b) the desirability of amending the MiFID to create a further category of investment firm whose main business consists exclusively of the

[3] Directives 2006/48/EC relating to the taking up and pursuit of the business of credit institutions (recast) and 2006/49/EC on the capital adequacy of investment firms and credit institutions (recast).

provision of investment services or activities in relation to the financial instruments set out in points 5, 6, 7, 9 and 10 of Section C of Annex I to the MiFID relating to energy supplies (including electricity, coal, gas and oil).

19. On the basis of this report the Commission may submit proposals for amendments to Directives 2006/48/EC and 2006/49/EC.

20. In the meantime, Art. 48 (1) of Directive 2006/49/EC temporarily exempts investment firms from the provisions on capital requirements laid down in that Directive and Directive 2006/48/EC provided -

    a) their main business consists exclusively of the provision of investment services or activities in relation to the financial instruments set out in point 5, 6,7, 9, and 10 of Section C of Annex I to Directive 2004/39/EC on Markets in Financial Instruments (MiFID); and

    b) Directive 93/22/EEC on investment services in the securities field (ISD) did not apply to them on 31 December 2006.

21. The exemption will terminate on 31 December 2010 or on the date of the entry into force of any modifications of the named directives as a result of the review undertaken according to Art. 65 (3) of the MiFID in connection with Art. 48 (2) and (3) of Directive 2006/49/EC, whichever is the earlier.

22. A similar temporary exemption is in place with regard to the large exposure rules (see Art. 45 of Directive 2006/49/EC).

23. The report provides a review of prudential practices for commodities business and firms carrying out commodities business as set out in Section C (i) of the Call for Advice. Section I focuses on the EU Member States and EEA countries and contains a survey of the national prudential supervisory regimes currently in place. As far as possible it also provides an overview of the amendments that will be required by the transposition of the MiFID and the CRD. Section II of the document (Third countries) reflects the information which was available until November 2006. The working group is further investigating in this area and might be able to provide additional information in the second submission in April.

# I. EU Member States (and other respondents)

## 1. Scope of the regime

### Current prudential supervisory regimes (overview)

24. The national supervisory authorities were asked which firms conducting business related to the instruments (options, futures etc.) and underlying products (oil, electricity, weather etc.) listed in Annex I, section C points (5), (6), (7), (9) and

(10) of the Directive on Markets in Financial Instruments (2004/39/EC – MiFID) are subject to a prudential supervisory regime[4].

25. The questionnaire distinguishes between:

    a) types of firms (credit institutions, investment firms or other firms)

    b) the relevant directives (ISD – 93/22/EEC; CAD – 93/6/EEC and Banking Directive – 2000/12/EC); and

    c) additional or alternative national legislation.

26. Of the twenty nine respondents twenty[5] stated that they subject their banks and/or investment firms engaging in commodities business to the ISD. In twenty three countries the commodities business is also subject to the prudential requirements of CAD or BCD[6].

27. Sixteen countries have additional or alternative prudential national legislation in place governing firms active in the commodity derivatives sector[7].

28. Five respondents[8] do not currently have financial firms active in the commodities sector.

29. Some countries distinguish between the activities carried out. Belgium, for example, applies no prudential requirements to pure commodity derivatives brokers[9] but portfolio management and investment advice with regard to commodity derivatives must be carried out by credit institutions and investment firms. Slovenia has implemented a special licence requirement for trading in derivatives and an obligation to notify every new product to the supervisor.

30. Only a few countries indicated the number of firms engaged in commodities activities. Significant numbers were given by the UK (13 credit institutions and 21 investment firms are supervised according to ISD and CAD/Banking Directive; 53 other firms according to additional national legislation), Latvia (20 credit institutions and 6 investments firms are supervised according to ISD and CAD/Banking Directive), Italy (12 credit institutions and 7 investment firms are supervised according to CAD/Banking Directive and additional national legislation) and Liechtenstein (15 credit institutions are supervised according to ISD, CAD/Banking Directive and national legislation).

31. A significant alternative supervisory regime for "other firms" carrying out commodities business was reported only by the UK. Here a prudential regime broadly similar to the CAD/Banking Directive regime is imposed on non-ISD commodity derivative firms. However, Oil Market Participants (OMPs) and Energy Market Participants (EMP) are or can be exempted from the prudential requirements.

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4 For a detailed summary of the current and future supervisory regimes please see Annex 2.
5 Belgium, Denmark, Germany, Greece, France, Ireland, Luxembourg, Netherlands, Austria, Portugal, Finland, UK, Cyprus, Hungary, Latvia, Malta, Czech Republic, Slovakia, Slovenia and Liechtenstein
6 The twenty-three countries that subject their commodities firms to CAD or BCD are Belgium, Denmark, Germany, Spain, France, Ireland, Italy, Luxembourg, Netherlands, Austria, Portugal, Finland, UK, Cyprus, Estonia, Hungary, Latvia, Malta, Poland, Czech Republic, Slovakia, Slovenia and Liechtenstein,.
7 Denmark, Germany, Spain, France, Ireland, Italy, Netherlands, Austria, Finland, Sweden, UK, Estonia, Hungary, Slovenia, Liechtenstein and Norway
8 Bulgaria, Finland, Iceland, Lithuania and Malta
9 This exemption will end with the implementation of the MiFID.

## Future prudential supervisory regimes (overview)

32. With the transposition of the MiFID, the current definition of financial instruments will be broadened to include certain commodity derivatives and derivatives relating to underlyings such as climatic variables, freight rates, emission allowances or inflation rates and other official economic statistics. Thus, a number of firms carrying out commodities business and business activities connected to commodities which are currently outside the scope of the EU Directives will become subject to supervision. This may lead to amendments being made to the current prudential supervisory regimes. Further changes may also be caused by the transposition of the CRD.

33. In some countries a number of investment firms currently not subject to the ISD will be subject to the MiFID (UK: 53 investment firms; Netherlands: 38 investment firms). However, in most countries the replacement of the ISD by the MiFID will have no impact on the number of firms supervised[10].

34. A number of firms will fall under the exemptions in Art. 2 (1) (b), (d), (i) and (k) of the MiFID and Art. 48 of Directive 2006/49/EC[11].

35. A number of countries note that the transposition process of the MiFID and the CRD is still on-going and that definitive information concerning future legislation cannot be given.

36. Firms only engaged in physical trading are not subject to prudential supervision in any of the countries responding. However, so far as they are members of an organised market it may be worthwhile including them in any consideration of the prudential treatment of this area.

## Specific prudential requirements (see Annex 3)

37. The Member States were asked to specify which activities listed in Annex I, Section A of the MiFID trigger which prudential requirements with regard to which underlying products listed in Annex I, C, points 5 to 7, 9 and 10 of the MiFID and whether different prudential requirements apply to different kinds of the named instruments.

38. Four countries[12] have not implemented prudential requirements with regard to the named activities and products.

39. In one country[13] the requirements are subject to the Industrial Code.

40. In five countries[14] the requirements differentiate between products. For example, in Germany different requirements apply to the calculation of capital charges for market risk for commodities and weather or other non-commodity "exotic" underlyings. Some countries distinguish between commodity derivatives traded on a regulated market or OTC. The UK distinguishes between oil and energy and all other commodities, taking into account its specific rules for oil market participants and energy market participants. In Norway, prudential requirements exist for business in exchange traded products.

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[10] See Annex 2, lit. f)
[11] See Annex 2, lit. h)
[12] Finland, Lithuania, Malta and Liechtenstein
[13] Austria
[14] Germany, Greece, UK, Latvia and Norway

41. Most countries apply different requirements to the different activities listed in Annex I, Section A of the MiFID taking into account the different risk content related to these activities. The most common requirement is the application of initial capital requirements according to the risk content of the activity, albeit the amount required may vary from country to country. Apart from that, some countries also impose minimum capital requirements on certain activities.

42. Four countries reported that they allow the use of VaR or CAD I models recognised by the supervisory authority for the calculation of capital requirements[15].

## 2. Risks addressed by national legislation (see Annex 4)

43. The questionnaire distinguishes between macro prudential risk, firm related risks and product/transaction related risks.

44. Overall, the responses show that national legislation, in general, does not specifically address commodities-related risks. In most instances, the risks arising from commodities business are addressed through provisions and methods that are already in place for non-commodities business or a variation thereof.

45. Only a few countries reported explicit provisions with regard to macro prudential risk. In those cases, they generally referred to a mitigation of macro prudential risk by broad regulation of the financial services markets, exchanges and firms, including non-ISD commodity derivative firms. Some countries also mentioned stress-testing for systemic credit institutions.

46. As regards macro prudential risk from the physical market in the underlying, one country mentioned the role of its gas and electricity regulator which, although focused on consumer protection, also addresses some market risks e.g. through licence requirements for wholesale energy market participants and ensuring investment in networks. However, it is assumed that the energy regulators in the other member states would have similar indirect effects in mitigating risks in the underlying physical markets for electricity and gas.

47. With regard to firm related risks, most countries have in place minimum capital requirements and internal governance requirements according to the CAD/Banking Directive and CRD. Liquidity risk requirements, including reporting requirements, apply as appropriate according to the respective national prudential regime.

48. Product/transaction related risks are addressed by different approaches according to the different risk categories. However, so far as the respondents have implemented regulations, the differences seem to be marginal.

49. With regard to market risk, most countries impose capital requirements. For the calculation of the capital requirements on their commodities business the firms may choose from different options, including the use of a maturity ladder or a VaR-model.

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15 Germany, Greece, Poland and UK

50. Credit risks also trigger capital requirements. The prudential regimes reflect the requirements laid down in the CAD/Banking Directive or the CRD respectively. Collateral may be used to mitigate credit risk.

51. Operational risk will be addressed in the future as part of the transposition of the CRD and will result in the imposition of capital requirements and organisational requirements. For the time being national legislation addresses operational risk only by qualitative requirements.

52. So far as commodities business touches the large exposure regime the respective prudential requirements - limits, reporting requirements and capital requirements - according to CAD/Banking Directive or the CRD apply.

53. Different prudential regimes apply with regard to counterparty risk. Whereas most of the respondents do not explicitly address this risk category some respondents require commodity firms to calculate a counterparty risk requirement on all counterparty exposure arising from their securities and physical commodities business.

## 3. Treatment of firms that are part of a group

54. No respondent explicitly distinguishes between commodities firms and commodities business depending on whether it is carried out within financial groups or non-financial groups. Generally, the usual rules for supervisory consolidation apply and determine whether a firm has to be consolidated and the respective prudential requirements applied. However, in the UK a group containing non-ISD commodities firms may be subject to non-directive consolidation according to national rules. These rules may also apply to groups that contain a commodities firm that is subject to the MiFID but falls under one of the exemptions.

55. No respondent reported specific rules for commodities business carried out within a financial or a non-financial group.

## II. Third countries

56. The Call for Advice asks for information on the supervisory regimes in place in non-EEA jurisdictions. CEBS has undertaken a limited desk-based review of the supervisory regimes for commodities business in place in three non-EEA jurisdictions, namely, the United States, Australia and Switzerland. The following overview reflects the information which was available until November 2006. The working group is further investigating in this area and might be able to provide additional information in the second submission in April.

## 1. Regulation of commodities business in the United States

### Scope of commodity regulation

57. Regulation of commodities and commodity derivatives business in the United States is primarily governed by the Commodity Exchange Act (CEA) and largely falls under the supervisory responsibilities of the Commodity and Futures Trading Commission (CFTC).

58. The CEA applies to products traded on an authorised commodity exchange, including agricultural commodities, physical commodities, financial instrument commodities (U.S. and foreign stock indices, U.S. and foreign government securities, foreign currencies), energy commodities (crude oil, petroleum, gasoline heating, oil and natural gas) as well as non-traditional commodities (electricity, seafood, dairy products, crop yields and weather derivatives).

59. Each U.S. futures exchange operates as a self-regulatory organisation, governing its floor brokers, traders, members and firms.

### Regulated Instruments

Futures and Options

60. Futures and options must be executed on the floor of a commodity exchange, with very limited exemptions, and through persons registered with the CFTC. All contracts are subject to the rules of a commodity exchange.

Spot and forward transactions

61. As a rule, neither spot and forward transactions in commodities, nor those who deal or advise in respect of them, are subject to a comprehensive scheme of regulation, including licensing or regulatory capital requirements. However, in respect of energy/power markets, dealers must register as power marketers with the Federal Energy Regulatory Commission. To qualify an applicant must demonstrate that it is neither a generator nor transmitter of electricity. There are no minimum financial requirements.

## Regulated Activities

62. Subject to limited exceptions, all commodities futures and options, are required by the CEA to be traded on a brokered basis on or through a CFTC regulated exchange.

63. The firms and individuals who conduct futures trading business with, advise or hold client money for, private customers must be registered with the National Futures Association ("NFA"). The following persons, subject to limited exceptions, also need to be licensed and regulated: a commodity pool operator ("CPO"), a commodity trading advisor ("CTA"), an associated person ("AP"), a floor broker ("FB"), a floor trader ("FT") and an agricultural traded-option merchant ("ATM").

64. Brokers are required to register as either a futures commission merchant ("FCM") or as an introducing broker and, in order to protect customers, to meet various disclosure, recordkeeping and reporting requirements, and financial requirements. Introducing brokers do not as a rule hold client money.

65. People who as a business advise others on, or operate collective investment funds trading in, regulated domestic or foreign commodities futures or options (Advisers), are required to be licensed and regulated and must meet disclosure, recordkeeping and reporting requirements. No capital requirements apply.

## Prudential regulation of commodities business

66. Minimum financial requirements for commodities business are contained in general regulations made under the Commodity Exchange Act. The minimum applicable capital requirement is calculated according to the regulated activity undertaken.

### Futures Commission Merchants and Introducing Brokers

67. Persons registered as futures commission merchants (FCM) must maintain adjusted net capital equal to or in excess of the greater of:
    a) $250,000; or
    b) the futures commission merchant's risk-based capital requirement, calculated as follows:
        i. eight percent of the total risk margin requirement for positions held by the futures commission merchant in customer accounts; and four percent of the total risk margin requirement for positions held by the futures commission merchant on its own account; or
        ii. the amount of adjusted net capital required by a registered futures association of which it is a member.

68. Each person registered as a futures commission merchant engaged in soliciting or accepting orders and client money from any customer who does not qualify as an "institutional customer" must:

a) be a clearing member of a derivatives clearing organization and maintain net capital in the amount of the greater of $20,000,000; or

b) receive orders on behalf of the customer from a commodity trading advisor acting in accordance with §4.32 of this chapter.

69. Introducing brokers must maintain adjusted net capital equal to or in excess of the greater of:

a) $30,000; or

b) the amount of adjusted net capital required by a registered futures association of which it is a member.

70. The level of minimum capital to be held by a broker-dealer is significantly affected by the instruments in which the firm trades. The same basic minimum requirements for FCMs apply to broker-dealers in relation to on-exchange transactions. However, for OTC derivatives transactions, SEC rules specify that OTC derivatives dealers shall maintain tentative net capital of not less than $100 million and net capital of not less than $20 million.

71. OTC broker-dealers may however apply for a waiver from these requirements and apply instead the applicable credit and market risk provisions that are based on Basel 1 requirements. This includes the possibility of using internal risk/VaR models for market risk.

### Group capital requirements

72. Minimum capital requirements may be calculated on a consolidated basis.

## 2. Regulation of commodities business in Australia

### Scope of commodity regulation

73. The regulation of commodity derivatives business in Australia is largely governed by the nature of the activities undertaken and instruments concerned. Subject to limited exemptions, dealing, advising and market-making in commodity derivatives requires authorisation by the Australian Securities and Investment Commission (ASIC).

74. There is no specific regulatory regime applying to specialised commodity dealers.

### Prudential Requirements

75. The Australian Prudential Regulation Authority (APRA) is responsible for setting detailed capital requirements in respect of banks/authorised deposit institutions (ADIs). Banks undertaking regulated activities in respect of commodity derivatives are currently subject to Basel 1 rules. APRA is in the process of implementing the revised Basel II framework. Institutions falling within the

supervisory remit of ASIC are subject to much more high-level, principles-based minimum capital requirements.

76. For those dealers/brokers undertaking commodity derivatives business subject to ASIC supervision, the basic minimum capital requirement is for the firm to have positive net assets and a simple solvency requirement (i.e. the ability to meet liabilities when they fall due). There is also a basic requirement for them to hold 3 months' operating expenses. Firms that hold client money over AUS $100,000, must hold an additional AUS $50,000 in surplus liquid funds. Where a firm has liabilities or contingent liabilities in excess of AUS $100,000, it must hold a tiered adjusted liquid funds surplus of between AUS $50,000 and AUS $100,000.

## 3. Regulation of commodities business in Switzerland

### Scope of commodity regulation

77. According to the Swiss Stock Exchanges and Securities Trading Act (*Bundesgesetz über die Börsen und den Effektenhandel* or BEHG), firms that trade in securities require a licence from the Swiss Federal Banking Commission (*Eidgenössische Bankenkommission* or EBK).

78. All derivatives are treated as securities under Swiss law. The Swiss Stock Exchange Ordinance (*Verordnung ueber die Börsen und den Effektenhandel* or BEHV) defines a derivative as a financial contract whose price derives from financial assets such as securities, bonds, commodities, precious metals, fx rates, interest rates or indices. This definition applies to both exchange-traded and OTC transactions.

79. However, the BEHV only regulates transactions in derivatives which are largely standardised and therefore suitable for trading on a large scale. A transaction is deemed to be "standardised" when it is available to the public (more than 20 investors) and has a uniform structure/denomination.

80. Non-standardised derivative transactions are not subject to regulation. Therefore, transactions created for an individual counterparty would not be regulated. Consequently, in practice, most OTC transactions do not fall within the scope of the BEHV.

81. Spot transactions in commodities are not regulated. There is no clear definition of spot transactions; the maximum settlement period is determined by market practices. However, the supervision of licensed security traders also includes spot trading activities.

82. Swiss law distinguishes between different types of securities traders, for example, traders on own account (proprietary traders), market makers, "derivatives houses" (derivatives providers) and traders acting on behalf of clients (broker/dealers). With the exception of broker/dealers, the BEHV applies only to firms which perform financial activities as their main business. Thus, industrial or commercial enterprises do not require a licence from the EBK for the ancillary trading activities carried out by their treasury departments or in group entities.

83. Proprietary traders are subject to regulation only for the sake of market stability. Therefore, a licence is required only if the volume of their dealings in securities (including derivatives) is in excess of CHF 5 billion per year.

84. Market makers are firms which respond to requests for quotes from the public on a continuous basis and are willing to deal on own account by buying and selling securities. If a firm which is active mainly in non-financial business wants to conduct market making, Swiss law demands that a separate legal entity be set up.

85. Broker/dealers who deal in their own name to execute client orders generally require a licence. Like market makers, they have to establish a special legal entity to keep the activity separate from other business. However, as the main objective of regulating broker/dealers is to protect clients, an exemption to the licensing requirement applies to those broker/dealers who deal only with institutional clients.

86. Brokers or portfolio managers who act only in the name of their clients are not subject to licensing requirements.

**Prudential requirements**

87. In order to be granted a licence, a securities trader must, *inter alia*, have an initial capital of CHF 1.5 million, the board members must demonstrate that they are trustworthy and sufficiently qualified in the business, and the shareholders must guarantee the proper conduct of the business of the firm.

88. The firms, including their outsourced business, are subject to organisational requirements which include, particularly, sound risk management systems. Firms have to set up internal policies and procedures to assess, limit and monitor all relevant risks. They also have to create internal control systems, including internal audit procedures. Their records and annual reports have to be audited annually by an external auditor.

89. Securities trading firms are subject to minimum capital requirements generally comparable to those which apply to banks under Basel I. However, the EBK is authorised to impose additional minimum capital requirements on securities traders as well as to ease some regulatory burdens. Small traders can apply for a de minimis exemption, which allows a simplified calculation of capital requirements. In the case of bigger firms, the methods applicable for measuring counterparty risk and market risk are the same as those applicable to banks. There are no special requirements concerning liquidity.

90. For customer protection, broker/dealers are subject to a code of conduct, which includes a requirement to provide their clients with adequate information.

91. Money laundering regulations apply to commodity transactions entered into on an exchange either for a client or for own account (if trading by the relevant entity exceeds the CHF 5 billion threshold). Any form of trading in precious metals is subject to Swiss money laundering regulations.

**Market**

92. There are no commodities exchanges in Switzerland. The domestic power market has not yet been liberalised. However, Swiss firms are active on the liberalised European wholesale markets. There are three energy derivatives trading companies being licensed. They predominantly trade on foreign exchanges on behalf of their parent companies. These companies applied for licences, because they wanted to become members of foreign exchanges and the EBK had set the pre-condition, that they must be licensed. These companies use collateralisation to mitigate counterparty risk, including large exposure risk.