14 July 2008 commodities@c-ebs.org

Dear Sirs

CESR-CEBS Consultation on Commodities

Introduction

1. The London Metal Exchange ('LME') is a UK Recognised Investment Exchange and a regulated market under the Markets in Financial Instruments Directive ('MiFID') that specialises in futures and options on base metals and plastics. Well established contracts traded on the Exchange are those on aluminium alloy, copper, lead, nickel, North American special aluminium alloy, primary aluminium, tin and zinc; relatively new contracts are those on steel billet, polypropylene and linear low density polyethylene. While LME futures prices for the established contracts are used widely to price dealings in the underlying physical metals, the three recently listed contracts are still building liquidity and their prices have yet to become widely accepted as reference prices for valuing physical contracts.

2. We answer below only those questions relevant to LME markets, LME members and their clients or those where we have relevant comments to make.

Part A: EU Commodity Derivatives Markets

3. As a general point, commodities and commodity derivatives are quite diverse in their user base, their coverage, and contract design. Consequently, we believe that CESR and CEBS should consider carefully whether what works for one commodity/commodity derivative will work equally well for other commodities and their associated derivatives. Key to note are:

   - Commodities such as oil or base metals are international markets unlike those in, say, electricity and piped gas, which are national or EU markets;
   - Internationally traded commodities and commodity derivatives operate in highly competitive, mobile, international markets, where market members and commodity/commodity derivatives users have a wide choice of where to do business;

- commodity derivatives requiring delivery of the underlying, such as those in base metals or agricultural commodities, are subject to different pressures from cash settled contracts such as the Middle East Sour Crude futures contract traded on ICE Futures, particularly in the area of market abuses such as squeezes and corners;
- certain commodity derivatives contracts traded on regulated markets such as those on the LME provide buyers and sellers of the underlying commodity with transparent reference prices which they use for their physical transactions in the underlying commodity (see paragraphs 7-9 below); and
- oil, gas and electricity majors are perhaps more likely than corporates active in other types of commodities to establish special subsidiary companies to provide limited derivatives services and/or to deal on own account, thereby being subject to exemptions in Article 2 of MiFID and coming within bespoke national regimes such as the Financial Services Authority (FSA) operated Energy Market Participants (EMP) and Oil Market Participants (OMP) regimes[1]. The LME is unaware of similar regimes being available or required for participants in ferrous metals and non-ferrous metals and their associated derivatives markets.

Part B: Market Failure Analysis

4. We are not aware of direct holding of LME Client Contracts[2] by private clients. The minimum contract size in, for example, primary aluminium is 25 tonnes. The current three-month price of copper is US$3,300, which gives a minimum contract size of US$82,500. The LME believes that the type of market participants who typically hold LME Client Contracts are knowledgeable, wholesale, professionals and who either use the commodities underlying the contracts traded in their daily business or who are experienced professional investors or eligible counterparties such as fund managers or credit institutions.
5. In paragraph 62 of the consultation it states that *unsophisticated investors* are disadvantaged by the fact that some commodity derivative contracts are subject to *'special price curves'*. Q.2 then invites agreement with the statement that the level of direct participation by private clients is low and that *unsophisticated investors* are mainly limited to corporate clients such as producers or wholesale distributors with a lack of experience and knowledge in derivatives markets but not in trading in physical markets.
6. While the LME agrees that there is negligible direct participation in commodity derivatives by retail investors it does not believe that corporates of the type mentioned are 'unsophisticated'.
7. Most physical commodity trading is bilateral with opaque pricing that is not revealed to other producers, processors, merchants, and consumers of the commodity. Commodity derivatives markets such as the LME, which list physical delivery contracts, offer transparent market prices that are used widely as reference prices by physical market participants to price their

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[1] The EMP and OMP regimes are for firms that restrict their investment activity to oil and energy derivatives and which do not deal with retail clients. Firms subject to these regimes benefit from special prudential requirements and a differentiated conduct of business regime that recognises the professional nature of the oil and energy markets while still subjecting the firms to the high level Principles of the FSA.

[2] An LME Client Contract is a contract between a clearing member of the LME and any person other than another clearing member or a contract between an LME member who is not a clearing member and any other person.

goods.[3] Consequently, such corporate clients cannot afford to be ignorant of or unacquainted with derivatives markets, their prices and their operations even if they do not use derivatives to hedge price or sourcing risk.

8. In commodity derivatives markets prices reflect the best estimates of disparate market participants of future supply, demand and the rate of inflation; depending on these factors, it is normal for futures price curves for commodities to vary between being in contango and in backwardation[4] - backwardations are not abnormal and are certainly not 'special' as alleged by the comment in paragraph 62 of the consultation. The future price discovery mechanism of derivatives grants those with exposure to price and/or sourcing risk the ability to hedge these risks.

9. In Q.3 the question is posed as to what informational advantages persist in commodity derivatives markets and to what extent those active in the underlying physical market have informational advantages. It may help before answering this question to explain briefly how the LME designs contracts to minimise such risks and so reduce the scope for abuse.

10. For both new and established contracts the LME establishes and sets the quality and brand of the underlying commodity that can be delivered to fulfil a seller's obligations under a contract. For example, for its primary aluminium contract there are 99 brands of 79 producers from 29 countries that can be placed on LME warrant[5] and used to meet delivery obligations; the equivalent figures for copper are 76 brands of 52 producers in 23 countries. Consequently, there is neither a monopoly nor an oligopoly of producers, brands or countries that produce material deliverable on the LME. This reduces the likelihood that changes to the circumstances of a single producer or even several producers or knowledge of any such events

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[3] The LME publishes daily Official Settlement Prices for the non-ferrous metals, ferrous metals and plastics derivatives that it has admitted to trading; this brings price transparency to an otherwise opaque market for these physical commodities. Producers, distributors and consumers of the commodities use LME Daily Prices, adjusted for differences in quality from acceptable LME deliverable brands and for International Commercial Terms such as Free On Board (FOB) or Cost, Insurance and Freight (CIF), to price their transactions for physical material delivered to locations throughout the world.

[4] A contango market is where prices for nearby delivery are lower than prices for deferred delivery due to supply exceeding demand for nearby and deferred dates; deferred prices in contango markets reflect the cost of carry of buying, storing, financing and insuring commodities, with arbitrageurs helping to ensure that forward prices reflect the cost of carry. A backwardation market is where prices for nearby delivery are higher than prices for deferred delivery due to demand exceeding supply for nearby and deferred dates. The forward price curve can fluctuate along its length between contango and backwardation depending on forecast supply and demand at discrete periods in the future. For example, base metals prices can be affected by strikes at mines or smelters, by the weather (a very cold winter leads to higher demand for batteries, which pushes Lead prices into backwardation), or by expectations of the effects on future supply and demand of whether and when economies are in or moving into boom, recession or depression.

[5] The LME prescribes the form that an LME warrant must take. For example, an LME copper warrant represents an identifiable 25 tonnes of a particular brand of grade A copper stored by a particular warehouse company in a particular location. The copper must be in the form of cathodes strapped in bundles and the warrant must state how many bundles are in that particular LME warrant. Each LME listed warehouse company undertakes to deliver out to the holder of an LME warrant the precise lot of metal that it represents. The majority of LME contracts are settled by offset but there are approximately one million LME warrant transfers annually.

will be critical to the well-being of the LME or give individual producers informational advantages.

11. The thousands of clients of LME members, most of which are active in the ferrous, non-ferrous and plastics that underlie the derivatives traded on the LME, have knowledge of supply and demand for the underlying commodities but it is a moot point as to whether this gives them informational advantages. For those clients such as fund managers who are not involved with handling the physical material but who invest in researching publicly available data and statistics on current and future supply and demand it is doubtful if they suffer any informational disadvantage to either producers or users of the commodities.

12. Due to the reasons given above and in answer to Q.3, the LME does not believe that informational advantages have resulted in a market failure with regards to the LME. As exchanges follow similar procedures to the LME when drafting contract terms we have no reason to consider that this would not apply to commodity derivatives traded on other regulated markets. Furthermore, as the transparency of prices traded on-exchange provides OTC and MTF participants with a visible benchmark for the pricing of related commodity derivatives we judge that applies equally to those marketplaces. There may be different circumstances in the electricity or piped gas markets that give rise to issues that do not arise in the same way with warehoused commodities. For example in the electricity markets we could see that there might be an asymmetry between those participants who are connected to the national grid and those who are not. However, that is not our area of expertise. The only point we would like to reinforce is that certain issues are not relevant for all commodities.

13. The explanations given immediately above also lead us to conclude in answer to Q.4 that price transparency and contract design mean that information asymmetries related to commodities that are traded as derivatives on regulated markets and related commodity derivatives traded elsewhere reduce mis-selling concerns.

14. In answer to Q.5, the LME is not aware of concerns having been raised about the current level of transparency relating to the trading of non-electricity and gas derivatives in the UK. The transparency of commodity derivatives orders and trades is not mandated by MiFID but is left to the discretion of Member States. In the United Kingdom the FSA requires regulated markets to have full pre- and post-traded publication of bids, offers and trades in commodity derivatives. There is no transparency mandated for commodity derivatives traded OTC or admitted to trading on MTFs authorised by the FSA.

15. For similar reasons given when answering questions 3 and 4 the LME does not believe in answer to Q.6 that there is evidence of informational asymmetries in its markets in relation to market abuse. While the LME has brought to FSA attention instances of possible attempts to manipulate its markets and offered full co-operation with subsequent investigations, there was no suggestion that the possible abuse arose as a result of informational asymmetries.

16. Turning to Q.8, members of the LME must be authorised by the FSA or be a MiFID-passported investment firm or be a credit institution under the BCD; none are specialist commodity derivative firms as defined in the consultation paper. Despite the absence of specialist commodity derivative firms as members, the LME is unaware of risks to the financial system arising from failure of any such firms or from losses suffered by those firms/corporations/funds mentioned in paragraph 97 of the consultation. Of the firms/corporations/funds mentioned we are aware of only two – Amaranth and Metallgesellschaft – that suffered catastrophic losses from

their dealings in commodity derivatives, with the second firm suffering from lack of cash to fund its rolling hedging programme although subsequent analysis revealed that the hedge would have been successful in achieving its aim if Metallgesellschaft had not been forced to liquidate it early. The other firms/corporations/funds mentioned suffered losses as a result of corporate fraud rather than from derivatives dealings.

Part C: Regulatory Failure Analysis

17. As has already been stated, commodity derivatives traded on regulated markets in the UK are subject to FSA transparency requirements. In response to Q.11, the LME is unaware of any demands for increased transparency of non-energy commodity derivatives traded OTC but believes that it is appropriate on competition grounds that MTFs trading commodity derivatives admitted to trading on regulated markets should have similar transparency obligations to those imposed on the regulated markets.

18. With respect to Q.12, the LME does not believe that the transaction reporting requirements in MiFID are the most effective means of supporting market regulation; the Exchange considers that position reports are more important to commodity derivatives markets in regulating markets for which they hold regulatory responsibilities. Regulated markets do receive matched trade reports of all transactions made subject to their rules as members must match and register them prior to the contracts being novated for clearing and settlement.

19. To ensure the integrity of commodity derivatives markets requiring physical delivery the LME considers that knowledge of positions held by users of their markets is essential; the LME requires all its members to report to it electronically each business day those LME warrants and trading positions held by their named clients and by the firm for own account for each futures settlement date and every options series as this allows the Exchange to aggregate positions across its market and so determine if any market participant holds dominant positions for any particular maturity date. Other regulated markets also monitor positions held, particularly for spot (or delivery) months.

20. Despite the importance of position monitoring, the LME does not believe that the MiFID transaction reporting obligation for trades in commodity derivatives should be replaced by an obligation on firms to make position reports to competent authorities; this would be too burdensome and inefficient for market participants because it would duplicate the position reports made to the exchanges which are available to the competent authorities. Nor does it believe that investment firms should be obliged to report transactions in commodity derivatives admitted to trading on regulated markets to competent authorities.

21. Given that MTFs and regulated markets have obligations under MiFID to ensure that trading on their markets is proper, that they monitor for market abuse, that they advise their competent authorities of instances of possible abuse and that they cooperate with the competent authorities in investing potential cases of abuse, the LME deems it appropriate to acknowledge the regulatory role of regulated markets and MTFs as frontline supervisors of activity on the markets and to leave it to them to monitor positions.

Part D: MiFID Questions 4 to 6

22. Q.19 asks if there is a case for changing the client categorisation regime as it applies to commodity derivatives business.

23. MiFID sets certain criteria that investment firms must comply with when categorising clients. MiFID defines a retail client as a client who is not a

professional client, with Annex II of the Directive stating that a professional client is "a client who possesses the experience, knowledge and expertise to make its own investment decisions and properly assess the risks that it incurs" before listing certain additional criteria. When it comes to clients using commodity derivatives these additional criteria appear inappropriate for clients hedging price or sourcing risk.

24. Members of the LME have informed the Exchange that many of their current and potential clients are small and would fail to meet the quantitative criteria listed in paragraph 1(2) of Annex II. Should the client/potential client be below the size limitations but wish to opt for treatment as professional clients rather than falling to be treated as retail clients MIFID prohibits firms from categorising the client as a professional unless the client complies with any two of having carried out transactions in significant size on the relevant market at an average frequency of 10 transactions per quarter over the previous four quarters, or having a financial instrument portfolio exceeding EUR 500,000, or working or having worked in the financial sector for at least one year in a professional position that requires knowledge of the transactions or services envisaged.

25. We would propose that for commodity derivatives the alternative criteria for a client wishing to opt for treatment as a professional client should be simply that the client has price and/or sourcing risk in the underlying commodity or closely related commodity.

26. In paragraph 213 of the consultation it states that CESR and CEBS do not believe that it is appropriate to differentiate the regulatory regime based on the underlying commodity, asset, right, service or obligation; Q.23 continues by asking if there are sufficient similarities between different commodity derivatives markets to make it inappropriate to differentiate the regulatory regime on the basis of the underlying being traded.

27. The LME recognises that it would be complicated to create a series of regimes that differ subtly depending on whether the underlying is, say, copper, steel, crude oil, electricity, cocoa or emissions, even though the regulatory issues raised by those commodities vary. However, it believes that there are good grounds for recognising the wholesale/professional nature of commodity markets and in drafting conduct of business and capital rules appropriate to those markets.

28. Indeed, we recollect that in the original November 2002 proposal to extend the ISD that the Commission wrote of the need to *"take account of certain features specific to trading in these [commodity derivatives] instruments, as well as the predominantly 'wholesale/professional' nature of the market participants. In particular, the proposal recognises the widespread presence of experienced traders active in the market for hedging/commercial reasons or acting exclusively on behalf of their parent companies affiliated subsidiaries."* We believe that the final wording of MiFID failed to recognise adequately the specificities of commodity derivatives markets and their users although acknowledging issues affecting certain specialist commodity derivatives firms active mainly in oil and energy.

29. In their December 2007 'UK discussion paper on the Commission's review of the financial regulatory framework for commodity and exotic derivatives' the UK's Treasury and FSA noted that it was perhaps timely to consider whether the EMP and OMP regimes could be extended to specialist firms dealing in products other than energy derivatives. Perhaps there is a need to go further and to consider not only whether there is merit in considering the need for a more general wholesale regime but in reviewing the conduct of business and client categorisation rules applying to corporate and

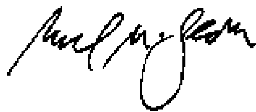
professional clients that appear capable of assessing the risks of using commodity derivatives in their business.

Complementary opt-in or opt-out regime

30. With regard to Q.31, the LME can see no downside in allowing firms that are exempt from MiFID the option to opt-in to a higher level of regulation and prudential supervision.

You can contact me at neil.mcgeown@lme.com, by telephone (+44 20 7264 5675) or by fax (+44 20 7264 5513) should you wish to discuss any points raised in this letter.

Yours sincerely



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