

Regulating the commodity markets: a guide to the role of the FCA

In this paper we explain the regulatory framework and the role of the Financial Conduct Authority (FCA) as it relates to the commodity markets. The FSA published a similar overview in 2007 as part of a wider paper, *Growth in commodity investment: risks and challenges for market participants*¹. Here we consider how the regulatory framework has evolved since then, and we also outline some of the changes that are expected from developments, primarily at the European level. We want this overview to be accessible and it does not constitute formal guidance.

The regulatory framework

We believe that commodity markets pose a set of specific regulatory challenges that need to be reflected in our policy and supervision. While regulated activities in commodity markets remain one of the smaller asset classes, commodity markets are unique in how their market activities straddle the regulatory boundary so that behaviour in the physical market can affect the financial markets and vice versa. This physical market activity is an increasingly key influence on the real economy. The European regulatory perimeter is under review, through the work on the Markets in Financial Instruments Directive (MiFID) and the Market Abuse Regulation (MAR), as part of a series of regulatory changes. This adds up to a situation of unprecedented complexity, which is a key driver of the direction of market development.

The UK regulatory framework

In the UK, responsibility for regulating certain activities in commodity derivatives was formerly held by the Financial Services Authority (FSA). The division of regulatory responsibilities between the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) in April 2013 has had no significant impact on how commodity markets are regulated within the UK. Indirectly, it should grant the FCA a more coordinated approach to promoting market integrity across market and firm supervision. Within the PRA, it should lead to a clearer focus on the prudential risks to banks arising from their commodities activities.

The international regulatory framework

The G20 has driven heightened standards for commodities markets with a number of initiatives, aiming to “improve the regulation, functioning, and transparency of financial and commodity markets to address

¹ http://www.fsa.gov.uk/pubs/other/commodity_invest.pdf

excessive commodity price volatility”.² These initiatives complement developments for wider derivatives markets to move towards central clearing and provide greater transparency, and will bring these markets more comprehensively within the scope of mainstream regulation.

As a key step, IOSCO published in 2011 its Principles for the Regulation and Supervision of Commodity Derivatives Markets, giving guidance on expected regulatory standards for members and reviewing implementation the following year. Like other EU states, the UK complies with the Principles; any shortcomings will be addressed by EU legislation currently under negotiation.³

What is the scope of regulation?

UK regulation

Commodity derivatives have been within the scope of UK regulation since the Financial Services Act 1986 (FS Act) came into force. The FS Act captured, amongst others:

- futures
- contracts for difference, and
- options on financial instruments (as well as currencies and precious metals)

Commodity derivative instruments were covered in the FS Act largely regardless of the underlying commodity market to which they relate. The effect of this was to bring exchange and certain OTC commodity derivatives markets within the scope of the FS Act. For futures,⁴ the scope is subject to an exception intended to exclude contracts entered into for commercial purposes, dependent on a number of conclusive and indicative factors. Most notably, instruments are within scope if traded on a Recognised Investment Exchange (RIE) and out of scope if for spot physical delivery.

The Financial Services and Markets Act 2000 (FSMA) did not materially change the scope of instruments covered. However, it affected firms in the energy market principally through abolishing the previous Permitted Persons regime, which had applied under the FS Act and which set nominal obligations upon firms. While the specialist Oil Market Participant (OMP) regime had existed under the FS Act, the Energy Market Participant (EMP) regime, in part based on the OMP model, was developed within the FSMA framework primarily because of the loss of the Permitted Persons regime, but also coincidentally because this was when energy trading markets in the UK were being significantly revamped, with the New Gas Trading Arrangements (NGTA) first and then, in April 2001, the New Electricity Trading Arrangements (NETA). FSMA also included a new ‘risk management’ exclusion, which has been relevant to commodity firms.

The FSMA 2000 (Exemption) Order 2001 (SI 2001/1201) also housed the gas industry exemption and the electricity industry exemption, which were designed to provide reassurance that direct participation in

² A summary of the developing international work can be found in the IOSCO report at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD358.pdf>

³ <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD393.pdf>

⁴ The term ‘futures’ under the FS Act also includes some physical forwards and does not relate exclusively to exchange-traded products.

balancing arrangements with the UK Transmission System Operators (TSOs) would not be a regulated activity.

European regulation

Under the Investment Services Directive 1993, commodity derivatives remained outside the scope of EU financial services legislation. This meant that firms were subject only to national capital requirements (where they existed) and were unable to passport commodities business across EU borders (where commodity derivatives were subject to national domestic requirements).

MiFID, which came into effect in November 2007, included commodity derivatives within the definition of financial instruments. There is a degree of overlap between the MiFID and FSMA definitions but they are not identical. Broadly, cash-settled contracts are within MiFID scope, as are physically settled contracts on Regulated Markets and Multilateral Trading Facilities. OTC physically settled contracts that have the characteristics of other derivative contracts and are not for commercial purposes were brought within scope in certain limited circumstances. The definition is complemented by various exclusions for specialist commodity firms, again somewhat different to those which exist under FSMA.

The definitions and exemptions are under review as part of the European Commission's review of MiFID, with the stated policy objective to enhance the regulatory grasp of commodity derivatives markets.

The UK chose not to align the regulatory perimeter under FSMA with that of MiFID, because at the time of implementation of MiFID the European Commission's review was already in prospect. FSMA is therefore more comprehensive in capturing firms under a domestic regime that are not within MiFID scope and the result has been to make the architecture of firm supervision more complex.

Recognised Bodies

Although the FCA has a direct interest in, and powers over, Multilateral Trading Facilities and the OTC market, a principal focus of our interaction with the commodity markets remains the three Recognised Investment Exchanges (RIEs) that offer trading in commodity derivatives:

- ICE Futures Europe
- LIFFE
- London Metal Exchange (LME)

Global trends of consolidation amongst exchange operation and ownership are increasingly relevant for these UK RIEs: the LME is now owned by Hong Kong Exchange & Clearing Group while ICE has taken over NYSE Euronext, which includes LIFFE. Additionally, since our last commodity market review in 2007 all three exchanges have made, or are instigating, changes to their clearing service provider, with a tendency to bring these in-house. Under the new regulatory framework, Recognised Clearing Houses are from April 2013 supervised directly by the Bank of England. The structure that Recognised Bodies operate under is essentially unchanged since the FS Act: they are exempt from the requirement to obtain authorisation provided they remain within the boundaries of their exemption. RIEs are subject to the Recognition

Requirements set out in secondary legislation and on which the FCA provides guidance within the FCA Handbook in the REC sourcebook.⁵

MiFID and Regulated Markets

From 2007, MiFID set out, among other things, standards across the EU for Regulated Markets. As MiFID now included commodity derivatives within the scope of investment products, this meant that ICE Futures Europe and LME were now categorised as Regulated Markets; LIFFE already was a Regulated Market because it facilitated trades in what were already financial instruments through its interest rate and equity derivative offerings. The UK regime was already largely consistent with MiFID standards, with a notable exception that a change of control process was now introduced, and operated most recently for the takeovers of the LME and LIFFE.

Enhancing market oversight

RIEs are considered front-line regulators of the markets they operate and have each taken various steps to enhance market oversight since 2007. ICE Futures Europe and LIFFE have initiated end-user position reporting, which is used internally for market monitoring and externally to improve market transparency by the publication of Commitment of Trader reports for certain contracts. The LME already has a form of position reporting in place to support its Lending Guidance regime. ICE Futures Europe additionally has implemented position limits and accountability levels for its 'linked contracts', which are those contracts priced off a CFTC regulated Designated Contract Market (DCM). ICE Futures Europe has implemented 'expiry limits' for its Brent contract, which apply in the run-up to expiry with exemptions available upon provision of documentation regarding underlying commercial activity. LIFFE has similarly implemented accountability and delivery limits for its commodities contracts with scope for exemptions based upon commercial activity. The LME has continued to focus on transparency in its telephone market and has reached improved levels of compliance with existing requirements.

Warehousing

The operation of warehouses licensed by RIEs is not a regulated activity. However, we have a formal interest in warehousing in relation to commodity markets because of the role it plays in ensuring that those RIE derivatives contracts which incorporate warehouse arrangements are anchored to the price of the underlying product and have effective settlement arrangements. RIEs have a contractual relationship with the warehouses and have terms and conditions by which the warehouses must abide.

There have been no recent material changes to the regime for Recognised Overseas Investment Exchanges, which is largely reliant on home regulators where their rules provide for equivalent levels of consumer protection and market integrity.

Multilateral Trading Facilities

MiFID introduced the regulatory classification of Multilateral Trading Facilities (MTFs), which granted specific permission to investment firms or market operators to facilitate multilateral deals in investments on a trading venue. This regime closely followed the existing FSA domestic regime for Alternative Trading Systems (ATSs). MTFs are subject to the FCA Handbook set out in MAR 5 (alongside the other FCA

⁵ <http://fshandbook.info/FS/html/FCA/REC>

regulatory requirements to which the operating firm is subject). MTFs are now supervised together within our Markets Division using a common template.

Firm supervision

Our approach to supervision

For all UK regulated commodities firms, we adopt the same approach as for other firms: making an assessment of impact to decide whether they should be relationship managed, thematically managed, or event-driven supervised from the FCA's firm contact centre. Relationship managed firms are subject to regular risk assessments using our risk assessment framework.

A number of market participants active in UK commodity derivative markets are not authorised firms and, for a class of market participants, an FCA-authorised firm is just one component of a wider physical, unregulated business.

MiFID firms active in the commodities markets are subject to the full requirements of MiFID in the same way as other investment firms. The exception is that MiFID firms whose main business consists exclusively of providing investment services or activities in relation to commodity derivatives (and who meet certain other conditions) can be exempted from certain capital requirements under the Capital Requirements Directive (CRD). This exemption⁶ is due to expire at the end of 2017.⁷

We continue to maintain various bespoke arrangements for supervising specialist firms active in commodity markets, particularly energy and oil market participants. These arrangements are concessions to the full firm supervision regime and focus on the prudential treatment of firms. Our conduct of business requirements still apply, subject to certain derogations if the firm is not a MiFID firm.

Participants in the commodity markets that do not qualify as Oil Market Participants (OMPs) or Energy Market Participants (EMPs) are regulated in a similar way to other investment firms. For those that are MiFID firms due to other business lines, for capital requirement purposes the applicable regime is as set out in BIPRU.

For commodity derivative firms that are outside MiFID scope but within the FCA's regulatory perimeter, and for those firms that are MiFID firms able to utilise the exemption from CRD – unless they qualify for EMP or OMP waivers – capital requirements are as set out in IPRU (INV) Chapter 3. The regime is conceptually similar to CRD but different in detail to reflect the operating models of the firms.

EMPs and OMPs

The EMP and OMP regimes are largely unchanged since 2007, other than an extension to cover biofuels, though the detail of application has been amended to reflect MiFID.

Financial reporting rules apply to all EMPs. Most EMPs have been authorised as broad scope firms but only act as arrangers; such firms provide the same financial reports as other arranger firms. EMPs must meet capital requirements and most have minimised their commitments through being set up as arranger companies for other group companies that hold the trading positions and significant fixed assets.

⁶ In the UK this is implemented at BIPRU TP15/TP16

⁷ Articles 493 and 498 of the Capital Requirements Regulation 575/2013

Only one EMP has been granted a waiver to the capital requirements. The EMP capital concession was introduced to encourage authorisation for energy firms with significant asset bases (such as power generators) to the market; these firms might otherwise be penalised by high liquidity charges on these assets.

OMPs are only required to submit close links and controllers' reports and are exempt from other regulatory capital requirements' apart from FCA's Principle 4 (to maintain adequate financial resources), which is interpreted as meeting liabilities as they fall due. An OMP would only be required to meet the financial resources requirement if, as a member of a Recognised Investment Exchange, it could trade with other exchange members under exchange rules. This last point dates back to the open outcry exchange model and has in recent years been interpreted pragmatically to reflect current market structures that members no longer access the market indirectly through the floor traders but are direct participants.

Commodity market participants that are banks are prudentially regulated by the PRA, with the FCA responsible for their conduct regulation only. Banking groups may of course include non-bank investment firm entities that would be sole regulated by the FCA and this can include entities qualifying for the EMP and OMP regimes.

There is close co-operation between the FCA and the PRA, underpinned by a formal Memorandum of Understanding⁸ signed last year.

Market abuse

Last year, the FCA concluded its first enforcement action in commodities.⁹ Our predecessor organisation, the FSA, also took enforcement action on a number of occasions in relation to commodity market behaviour.¹⁰

The FSA published its Code of Market Conduct (the Code) in 2001. The scope of the Code was linked to 'qualifying investments admitted to trading on a prescribed market', which from the outset included all RIEs. So behaviour on commodity markets was within scope from that time, although there were no provisions of the Code that addressed the particular characteristics of commodities trading apart from within a specific safe harbour for the LME. The UK regime was therefore super-equivalent to the rest of the EU in the period between the implementation of the Market Abuse Directive in July 2005, which applied a market abuse regime to Regulated Markets, and the implementation of MiFID in late 2007, at which point commodities RIEs were treated as Regulated Markets.

⁸ <http://www.fca.org.uk/your-fca/documents/mou-between-the-fca-and-the-pracoordination>

⁹ 2013 – finding of market abuse against Michael Coscia, an oil trader:
<http://www.fca.org.uk/news/fca-fines-us-based-oil-trader>

¹⁰ 2009 - finding against David Redmond, an oil and freight trader:
<http://www.fsa.gov.uk/library/communication/pr/2009/065.shtml>

2010 - finding of market abuse against Stephen Perkins, an oil broker:
<http://www.fsa.gov.uk/library/communication/pr/2010/109.shtml>

2010 – finding of market abuse against Andrew Kerr, a broker in the coffee market:
http://www.fsa.gov.uk/pubs/final/andrew_kerr.pdf

In 2011, the Regulation on Wholesale Energy Market Integrity and Transparency (REMIT) introduced a market abuse regime and transaction reporting specifically related to physical gas and power markets for activities that are outside MiFID scope. The principal regulatory authority for REMIT in the UK is Ofgem and legislation prescribes the terms of interaction between FCA and Ofgem in fulfilling their respective responsibilities. In practice, we work closely with Ofgem – the FSA and Ofgem first put in place co-operation arrangements in 2002.

Looking forward: European legislation

There are four pieces of European legislation that will have particular impact on the regulatory framework for commodities. In each case, the legislation has a wide market scope and the treatment of commodities is not central. At the time of writing, each measure is at a different stage in the European legislative process.

EMIR: The European Markets Infrastructure Regulation is being implemented over the next few years. It brings greater transparency to regulators through reporting to trade repositories (which started on 12 February 2014) and reducing systemic bilateral risk through mandatory clearing obligations and risk mitigation requirements for un-cleared OTC trades (expected to start in 2014 or 2015 although the obligation to confirm trades within defined time periods is already in force). The clearing obligation applies to non-financial firms subject to a hedging exemption and thresholds; these firms are already required to notify the FCA if they are over the threshold and some commodity firms have done so.

MiFID: The revised MiFID and accompanying regulation (MIFIR) has received provisional political agreement. It will introduce a requirement for position limits, supported by a position reporting regime, across Regulated Markets, MTFs and a new category of platforms called Organised Trading Facilities. It will also enhance the requirement for transaction reporting for commodities, and extend this to transactions on MTFs and OTFs, as well as making changes to market transparency.

The extensions to the regulatory perimeter under the revisions to MiFID are likely to bring more firms within regulatory scope. Although the impact of this is not yet clear, it is thought unlikely to require any changes to the FCA's supervisory structure.

MAR: The Market Abuse Regulation has also received provisional political agreement. Its provisions will significantly advance the scope of the current regime through increased scope to include behaviour on MTFs and OTFs as well as Regulated Markets. It will extend to manipulative behaviour in physical commodity markets (except where covered separately by REMIT), which we consider is likely to have an effect on the financial market. It will also capture attempted market abuse and manipulation that affects benchmarks. MAR will also provide for cooperation and information sharing arrangements with energy regulators as part of the REMIT framework.

The changes introduced by MAR will significantly increase the regulatory grip over conduct on commodities markets and are intertwined with the changes under MiFID and EMIR that increase the visibility to regulators of market activity.

Benchmarks: The European Commission published in September 2013 its proposal for a Regulation on indices and benchmarks.¹¹ This proposal is wide ranging, applying to benchmarks used in financial markets,

¹¹ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2013:0641:FIN:EN:PDF>

but encompassing also those benchmarks relating to commodity markets. IOSCO is also taking forward work on benchmarks and, specific to commodity markets, on oil Price Reporting Agencies (PRAs).

The regulatory framework continues to evolve through and beyond the implementation of these measures. We will continue to work with market participants through this process to ensure an effective, robust and proportionate approach to commodity market regulation.