Association française des marchés financiers

LES PROFESSIONNELS DE LA BOURSE ET DE LA FINANCE

Commissioner Michel Barnier
Commissioner for Internal Market and Services
European Commission
BERL 10/034
B – 1049 Brussels
Belgium

Michel.barnier@ec.europa.eu

Minister Michael Noonan
Minister for Finance
EU Council's Presidency
Merrion Street
Dublin 2
Ireland

minister@finance.gov.ie

Chairwoman Sharon Bowles
Economic and Monetary Affairs Committee
European Parliament
Rue Wiertz
B – 1047 Brussels
Belgium

Sharon.bowles@europarl.europa.eu

Paris, 26 April 2013

Re: Commodity derivatives in the MiFID review

Dear Commissioner Barnier,

Dear Chairwoman Bowles,

Dear Minister Noonan,

Association française des marchés financiers (AMAFI) has more than 120 members, including credit institutions, investment firms, and operators of trading and post-trade infrastructures active in cash and derivatives markets for equity, fixed income instruments and commodities. Our members, one-third of which are subsidiaries of non-French firms, have some 10,000 employees.

Naturally, AMAFI has closely followed recent discussions on plans to revise the Markets in Financial Instruments Directive (MiFID) and Market Abuse Directive (MAD), which are crucially important to the market participants it represents. It has already voiced concern on several occasions regarding numerous aspects of the proposals, specifically those related to markets in commodity derivatives – agricultural[2] commodities, metals, energy (oil, gas and electricity), carbon emissions – on which several of its members operate.

Considering, on the one hand, the draft Market Abuse Regulation (MAR) adopted by the ECON Committee of the European Parliament on 9 October 2012 and the most recent compromise proposed by the Cypriot Presidency on 30 November 2012, and, on the other hand, the two draft laws revising MiFID, as adopted by the plenary session of the European Parliament on 26 October 2012, and the Council's draft compromise of 1 March 2013, AMAFI would like to draw attention to five issues that it believes need further review:

- Some unregulated market participants need to be brought under MiFID, albeit gradually;
- An effective system of position limits has to be based solely on clearing houses and their members;
- The framework for a harmonised, exhaustive system for position reporting needs to be clarified;
- Physically settled futures must remain within the scope of financial instruments;
- When bringing commodity derivatives under MAD, consideration must be given to an adequate framework of information relating to the underlying physical market.

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1. Some unregulated market participants need to be brought under MiFID, albeit gradually *(MiFID, art.2(1)(i))*.

Unregulated commodity futures dealers would not be covered by MiFID if they are carrying on an activity that is ancillary in relation to their group's main business and if they do not execute clients' orders for own account.

Given that some of these participants have a significant position on commodity futures markets, this exemption would clash with the aims of the ongoing review, i.e. to make the market operate smoothly and protect clients more effectively. Instead, logic ought to dictate that MiFID encompasses all companies – regardless of the percentage of revenues they generate for their parent – that do a sufficiently large amount of business relative to the markets on which they deal or that provide services to persons not belonging to the same group. In any case, it is hard to accept that a few large groups can do significant deals on behalf of third parties outside of MiFID solely because that activity is marginal relative to the group's main business. These third parties have every right to expect that their financial service provider will offer all the guarantees that European lawmakers see fit to put in place.

To do otherwise would be questionable considering that the G-20 wants the same rules applied to all participants, regulated or not, that offer the same services. This is one of the key work areas of the Financial Stability Board.

That said, it is true that bringing firms under MiFID will be a cumbersome process, forcing them to make numerous and significant changes to their systems and procedures. This is clear from the experience of the credit institutions and investment firms that implemented MiFID in 2007. Although this constraint has to be taken into account so as not to unduly destabilise companies that play a major role in the European economy, it must not be used to challenge the directive's fundamental principles. AMAFI believes it vital to set up a timeline based on the concept of substantial activity relative to markets and clients, and to gradually lower the criteria for gauging that "substantial activity".

2. An effective system of position limits has to be based solely on clearing houses and their members (MiFID, art.*59*).

Regarding position limits for commodity derivatives participants, AMAFI has long supported such a mechanism as a way to make commodity futures markets work better for end users – i.e. producers, industrial groups and merchants. However, the US market authorities have encountered protracted difficulties in setting such limits, thus highlighting the risk of making markets less efficient while actually trying to achieve the opposite.

This being the case, AMAFI believes two types of position limits should be clearly distinguished. On the one hand, limits that should be overseen by each market participant, which must take care not to place orders that would cause its positions to overshoot its limits. On the other hand, there are limits that must be monitored by clearing houses. Because clearing houses know the positions of each member and, in some cases, each of their clients, they can force them to reduce positions that exceed authorised limits. The first type of position limits are determined ex ante, the latter ex post.

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This is an important distinction, because ex ante limits are entirely dependent on the commitment that each position-holder makes to respect them, while only the regulator, by performing ex-post controls, can catch any lapses and sanction them. Furthermore, market participants and their members are unable to monitor these limits in real time. Since they are aware only of the transactions they carry out for their clients, they are unable to monitor the trades that those same clients may be making through other participants. By contrast, ex-post limits have proven effective, although that efficacy is diminished by the fact that participants can execute transactions on different markets and thereby exceed allowable limits on one market by taking extra positions elsewhere.

For this reason, AMAFI believes that efforts should focus on this last aspect, which, combined with LEI identification (see below), is undoubtedly the best way to ensure utmost efficiency at the lowest possible cost in the short to medium term.

3. The framework for a harmonised, exhaustive system for position reporting needs to be clarified (*MiFID, art.60*).

There is no question about the need for smooth and efficient reporting of positions taken by participants in commodity derivatives markets. The draft directive calls for reporting to be organised by the operators of the platforms on which these products are traded. Nevertheless, although these operators provide services to participants, who are required to give them the information they request, they can also find themselves in the position of competitors within the business segment. Consequently, at the very least, there is a need for strict rules governing information barriers and conflicts of interest to ensure that practitioners do not use this information unfairly. If this is not possible, a system of direct reporting to each regulator should be favoured.

Furthermore, the conditions for publishing the data gathered from this reporting process need to be specified. Simply indicating that trades must be reported weekly is not enough, because this could result in disclosure of material information about an as-yet unhedged position, thereby unduly exposing a given participant. AMAFI believes that weekly publications should not encompass positions that, owing to their size, are eligible for delayed disclosure.

Lastly, in keeping with the G-20 recommendations of October 2010, AMAFI stresses that the system’s effectiveness is directly linked to its ability to aggregate, without risk of error, the different positions taken by a single participant on both the physical and derivatives markets. From this point of view, the Legal Entity Identifier (LEI) initiative is of fundamental importance in this respect and should be strongly supported.

4. Physically settled futures must remain within the purview of financial instruments (*MiFID, Annex I-C*).

There is currently a debate about the option to exclude physically settled derivatives from the scope of financial instruments. The aim would be to limit, if not totally prevent, “financial speculation” on products that, hopefully, will continue to be used solely by producers, industrial groups and merchants. However, it is important to point out that these entities primarily use derivatives to hedge their risks, not as a means of buying or selling the underlying interest at maturity.

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Say, for example, that a farm cooperative is committed to delivering a quantity of wheat at a given price on a given date as a result of a call for bids in a North African country. The cooperative will hedge the risk of an unfavourable shift that causes the commitment price to deviate from the price at which it can procure the necessary wheat from the cooperative members after their harvest, plus any additional purchases if necessary. If such a price change does occur, then the cooperative can liquidate the derivative position and offset its loss by receiving the difference between the two prices. From this perspective, the futures market is used primarily as a hedging instrument, especially considering that the quantities in question –several hundreds of thousands of tonnes in our example – far exceed the market's physical delivery capacity. It would be unrealistic for the cooperative to hope to honour its commitment solely by exercising its derivatives. In reality, it would only be able to demand physical delivery, partial at best, to obtain any missing amounts of wheat.

With respect to the MATIF wheat future, a physical delivery contract widely used by sector producers and industrial groups, which recognise it as a European benchmark, it is important to note that less than 1% of these futures contracts were settled by physical delivery, i.e. 0.06% in 2012. In fact, the main appeal of physically delivered futures is to ensure that, at maturity, the futures price deviates as little as possible from the spot price. If the two prices do not converge, then the party making or taking delivery upon expiry would have no interest in the transaction because the trade would be made at a less advantageous price that that available on the spot market.

This being the case, AMAFI believes that "removing" physical delivery futures from the list of financial instruments would have a major disadvantage, namely it would deprive the contracts' users of the protection available under MiFID and MAD.

5. When bringing commodity derivatives under MAD, consideration must be given to an adequate framework of information relating to the underlying physical market

Including these derivatives is certainly necessary to provide the confidence without which commodity derivatives markets cannot effectively perform their role. Nonetheless, AMAFI notes that their inclusion would create difficulties because derivatives markets and physical markets are interlinked. In effect, market abuse on the derivatives market is often related to information regarding the physical market or transactions conducted on it. Unlike financial instrument markets, however, where the concept of market abuse has been shaped progressively by regulation and case law, while issuers' disclosure requirements were being clarified under the same conditions, the same relationship does not exist between commodity derivatives markets and the underlying physical markets.

In fact, this shortcoming is the reason the G-20 decided to set up the Agricultural Market Information System (AMIS) under the auspices of the UN Food and Agriculture Organization. Launched in June 2011, AMIS comprises key data on a selection of commodities, although the information will not be reliably available for several more years.

AMAFI believes this aspect must be taken into account to avoid creating significant legal uncertainty that could disrupt the smooth operation of commodity futures markets for a long time to come.

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AMAFI is grateful for the chance to submit these observations and welcomes any requests to discuss these matters at greater length.

Sincerely,

Pierre de Lauzun
Chief Executive

Copy to:

Jonathan Faull, Director General, DG MARKT
Maria-Teresa Fabregas, Head of Unit G3: Securities Markets