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European regulatory change: What it means for the metals market

From the LME Regulation Team

Europe is preparing to implement some of its most far-reaching financial services regulation in the next few years, and the global financial community – including the commodity markets – faces a period of unprecedented regulatory change, increased oversight and tighter scrutiny.

Increased regulatory focus since the financial crisis of 2008 has led to a more concentrated global regulatory force. Swathes of regulation have been introduced to govern previously untouched areas of the financial markets and to increase scrutiny on those areas seen to pose the most risk to financial stability.

The commodity markets fall within the wide-ranging reach of these proposed regulations. However, it seems little attention has been focused – by regulators and to some extent the industry – on how the new rules will affect these markets in particular. Commodities are different to other asset classes. They are tangible assets that have the potential to be physically delivered, and the market is truly global in nature. The metals industry is all about a real supply chain, from the mines to smelters and producers to consumers.

The London Metal Exchange (LME) is committed to ensuring that the exceptional nature of the metals industry is understood by global, EU and national regulators.

The risks in the commodity markets are not comparable to those in other areas of the financial markets. If regulation is not tailored accordingly, it could risk irreparable damage to the wider industry, leading to a reduction in market participants, a trading shift to non-EU venues and reduced liquidity.

It is crucial that participants in the metals markets, whether transacting on exchange or over the counter (OTC), are fully aware of the rules and regulations that will affect their businesses. They must be prepared for the incoming regulation, both in terms of the increased financial resources needed for implementation and the changes to fundamental business structures the new rules will entail.

The Markets in Financial Instruments Directive (MiFID II)

The Markets in Financial Instruments Directive (MiFID) governs all areas of the European financial markets. Its second iteration, MiFID II, will draw a greater range of firms within its reach – including many in the metals industry, such as commodity traders. Some of these firms may be required to obtain authorisation under MiFID II for the first time.

MiFID II is designed to reduce systemic risk in all financial markets by implementing a number of transparency measures, as well as improving investor protection and controls on trading venues such as the LME. The LME has begun an implementation programme for MiFID II. This programme is focused on minimising disruption to core functionalities for its members.

The new rules expand the definition of “MiFID business” to capture many new markets in the EU. Many proprietary firms trading commodity

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derivatives were previously able to rely on exemptions under MiFID I, but MiFID II limits the scope of those exemptions. This could bring many proprietary trading commodity firms within the regulation's remit.

MiFID II retains exemptions for non-financial business trading for risk management purposes. However, even where firms are able to continue to benefit from exemptions, there may still be situations where the products they are trading come under the new legislation.

Ancillary activity exemption

MiFID II has tightened the "ancillary activity exemption" whereby firms may engage in commodity trading or investment services as an ancillary to their main business. MiFID II will apply a quantitative methodology to determine whether firms can continue to claim this exemption. Firms will be obliged to notify EU member state regulators annually that they are claiming an exemption, and regulators will ultimately determine whether this is permissible. Regulators will assess how much this ancillary activity accounts for at a group-wide level. They will also review how much this ancillary activity accounts for in overall market activity in the relevant asset class.

Firms that are currently exempt from the scope of regulation should begin to consider how they will be affected by these changes and, where appropriate, begin planning for prospective authorisation.

Commodity derivatives position limits

Under MiFID II, the commodity derivatives industry will face position limits for the first time, although the exact volumes at which these thresholds will be set remains unclear. These limits will apply to any institution trading commodity derivatives in the EU, and to any net position held by an individual firm or within a group. Regulators will have the power to stop any trades that breach the limits and take enforcement action accordingly.

Limits will be set by national competent authorities (NCAs), although it has been suggested that regulators will work closely with trading venues in determining how to manage the limits. There will be two methodologies used by NCAs. For "spot months" (defined as the nearest contract expiry date) the limit will be set with reference to the deliverable supply and the default limit will be 25%. For all other contract expiry dates, the limit will be set with reference to the on-exchange open interest, and again a default limit of 25% will be used.

MiFID II governs all areas of the European financial markets. Many proprietary trading commodity firms could come within its remit

The first question is how to define "deliverable supply". While the latest European rules offer some guidance on this question, greater clarity is required to establish whether the volume will be measured as the level of stocks held in exchange-nominated warehouses or the deliverable global supply. It is critical that the volume of deliverable supply is calibrated correctly to ensure that legitimate hedging activity can continue to take place.

In addition, financial participants that seek to take a directional view on the market should be able to do so without risking inadvertent regulatory breach. Their activity provides liquidity to the markets and any overly restrictive limit regime has the potential to reduce this liquidity to the overall detriment of the market.

Given the global nature of the LME market, the only way to ensure this is to set the value of deliverable supply at a global level. This ensures

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position limits will be effective in capturing truly abusive positions without affecting genuine market users' ability to trade efficiently and manage their risk.

European regulators recognise that the proposed methodologies may require discretionary application and have allowed for flexibility whereby regulators may amend the default limit within the range of 5–35% of deliverable supply/open interest, as appropriate. However, until there is greater clarity around the definition of "deliverable supply" there will be concern that this flexibility will prove insufficient.

The LME's lending guidance was specifically designed for our unique prompt date structure, and is an effective and robust way to manage dominant positions

European regulators have also confirmed that there will be exemptions for legitimate commercial hedging activity of commodity derivatives. However, little has been provided so far about the exemption regime, and this lack of clarity has caused concern among businesses about their ability to legitimately hedge. Non-EU institutions might elect to hedge their positions outside the EU, leading to a loss of liquidity on EU venues, or simply to not hedge their positions at all, leaving participants exposed to market volatility.

Market operators and investment firms will be responsible for reporting positions to national regulators, who will assess whether position limits have been breached. This could be particularly challenging in the metals space, given the fragmented and globally diverse nature of the metals supply chain.

It is important to note that a large, or dominant, position should not be viewed as abusive *per se*. This assessment should instead be based on how the position is managed over time – as it is this behaviour that could give rise to concerns about its market impact.

Market integrity is core to the LME's ability to maintain an orderly trading venue. Under our existing position management system (or "lending guidance") a particular participant may validly own a large proportion of open interest, but they cannot use that to squeeze the market. A participant with a dominant long position must "lend" back to the market at a predefined spread, so their ability to squeeze the market would be inhibited.

The LME's lending guidance was specifically designed for the Exchange's unique prompt date structure, and is an effective and robust way to manage dominant positions on our trading venues. For this reason, the final position limit requirements set by the UK regulator are expected to be complementary to the LME's own existing position management rules. Replacing the LME's lending guidance with a "one-size-fits-all" position limit regime could have materially negative impact on the market. The LME is therefore working closely with the UK Financial Conduct Authority (FCA) to ensure that the lending guidance and position limits regime can co-exist and be mutually beneficial to all market participants.

Open access

MiFID II introduces the concept of "open access" in an effort to promote greater interconnectedness among market infrastructures and encourage competition.

The open access provisions stipulate that trading venues must be able to ask any suitable central counterparty clearing house (CCP) to clear their trades, and CCPs must be allowed access to a trading venue and the relevant data

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feed needed to clear instruments traded on that venue. The grounds for any venue or CCP to deny access to another under the new provisions are narrow.

Open access raises a number of issues that might not be conducive to market stability or the reduction of systemic risk in financial markets. This could ultimately lead to fragmentation of market liquidity and increased levels of risk for LME members and end users.

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As a metals exchange, the LME deals with unique product sets. Open access could raise problems with regards to the concept of economic equivalence, whereby open interest held across different venues is pooled. This could potentially permit an LME contract to be settled against non-LME-grade metal.

The clearing house for the LME market, LME Clear, believes that greater interconnectedness could exacerbate systemic risk, as one failing CCP could cause contagion at the other CCPs to which it is connected. For example, clearing members post margin as collateral to CCPs to cover the risk of clearing their transactions. In situations where markets become excessively volatile, the increased interconnectedness of CCPs could lead to widespread cyclical margin call activity at CCPs – that is, many CCPs will ask their members for additional margin to cover risk at the same time. The enhanced systemic importance of CCPs means the stability of these market infrastructures must be at the forefront of the regulatory agenda.

The implementing provisions of the regulation state that open access should only be granted in circumstances that do not threaten market stability or hinder the orderly functioning of markets, in particular as a result of liquidity fragmentation. The LME has called on regulators to think carefully about defining the grounds for denying access under the new provisions. End users of the commodity and metals markets – such as pension funds, asset managers, corporates, industrials and miners – are highly reliant on deep, liquid markets to effectively and efficiently manage price risks.

Should the LME face any open access requests following the introduction of MiFID II, maintaining the liquidity and security of its markets will be its key priority when considering whether to accept such a request.

Capital requirements

The wider scope of MiFID II means a greater number of commodity industry participants will need to obtain a regulatory licence. This will, in turn, mean they become subject to other EU regulations in force: the Capital Requirements Directive IV (CRD IV) and the Capital Requirements Regulation (CRR). To comply with CRD IV and CRR, firms will have to meet certain requirements relating to remuneration and the maintenance of regulatory capital.

The regulatory capital rules apply to all regulated firms, and many commodity trading firms are already subject to capital requirements. However, smaller commodity proprietary traders that are not currently subject to EU regulation might now need to consider what the new rules will mean for their business.

The maintenance of regulatory capital can impose onerous obligations on firms and may impede a firm's ability to trade and take trading risks. Such firms might find that the weight of regulatory capital requirements is disproportionately heavy, given their relatively

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small profile. The unintended consequences of the extended application of CRD IV and CRR could be that firms will be restricted in the way they do business, or have to restructure their activities. Ultimately, they might choose to leave the EU, which could lead to a reduction in liquidity in the region.

The LME understands the policy objectives behind imposing capital requirements on institutions that take on significant levels of debt to finance their trading activities, or on institutions that introduce unacceptable levels of systemic risk to financial markets. However, the requirements will affect smaller commodity trading firms disproportionately, given the limited levels of debt that they take on and the lack of systemic risk they pose.

Commodity firms were able to manage the stresses of the financial crisis well: no formal or informal government support was required in the sector and commodity trading firms were able to continue providing liquidity to the financial markets in circumstances in which other types of firms were unable to do so.

LME Clear is working with its members to mitigate the impact of regulatory requirements to hold capital against the notional value of outstanding positions. Its trade-compression service set for launch in November could reduce the notional value of a member's positions by as much as 90%, which may lead to capital efficiencies.

Remuneration restrictions

Commodity firms brought within the remit of CRD IV will become subject to procedures and restrictions governing remuneration. Restrictions apply to senior personnel whose day-to-day roles have a material impact on the risk profile of the company, and to any employee who has earned more than €500,000 in the previous financial year.

The rules place restrictions on bonus payments, and set the salary-bonus ratio for affected persons at 1:1 (or 1:2 with shareholder approval). Bonuses must also be paid out in approved financial instruments or shares, a percentage of which must be deferred for a specified period of time. Bonuses can also be clawed back by the employing firm in certain circumstances.

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While it would be possible to introduce increased fixed remuneration this will impact the perceived risk profile of the firm and increase the level of regulatory capital it will need to maintain.

In addition, firms are required to publish details of remuneration and establish internal governance procedures and remuneration committees. These requirements could present operational and legal issues for some commodity firms.

The Market Abuse Regulation

The Market Abuse Regulation (MAR) comes into force in July 2016 and is being introduced to modify the existing legislation governing this area. The new regulation is broader in scope, and focuses on identifying and eliminating abusive behaviour in all sectors of the financial markets.

Commodity firms will be subject to MAR when the contracts they trade come within the regulation's scope – it does not matter whether the firm is authorised or not. This means that commodity traders will need to consider how they will comply with the rules, and what their

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compliance obligations and costs will be. The scope of the regulation is wide: in addition to covering instruments traded on regulated markets such as the LME, it also captures manipulation of physical commodities, spot contracts and OTC contracts.

This means that commodity trading firms should take account of all of their trading activities throughout the value chain to assess where they may be at risk.

Physical commodities

Management of physical commodities will be directly affected by the new regulation. Where a physical commodity is stored or transported in a way that could distort the level of available supply, this may be deemed manipulative if that distortion affects the on-exchange traded price of the associated derivative. For example, failing to disclose the level of a stored commodity in a warehouse in order to increase the perceived value of that commodity could be deemed to be manipulative.

MAR is likely to affect how commodities are stored, and national regulators are increasing their scrutiny on warehousing arrangements in these markets

MAR is likely to affect how commodities are stored and shipped, and national regulators are increasing their scrutiny on the warehousing arrangements in these markets. The LME has adopted a forward-thinking approach to mitigate abuse in the warehousing system, and in November 2013 implemented a 12-stage reform package designed to improve the transparency and effectiveness of the LME's physical delivery network. The LME therefore believes it is well placed to manage the risks associated with the introduction of MAR.

Increased reporting

MAR extends its reporting requirements regarding suspicious transactions to cover suspicious orders as well. There is an additional obligation for firms and trading venues to record "near misses" – where irregular trading activity may have occurred – but it is not sufficiently clear whether or not a report is required. This is intended to ensure that firms and venues remain vigilant and are taking the correct decisions.

Firms will also be required to rigorously document their internal procedures and policies as to how they comply with MAR. These rules will mean commodity firms will have to introduce internal checks and governance processes to ensure compliance. The LME is already looking at this from a market surveillance perspective, and is introducing the requisite systems changes to accommodate this legislation.

The EU Benchmark Regulation

The EU's new Benchmark Regulation seeks to improve the operations and governance of industry benchmarks, and includes commodities among the asset classes it covers. The new rules are likely to be published in early 2016, with implementation expected to be around 2018. All European benchmarks will be subject to additional supervision to restore market confidence following the recent LIBOR and EURIBOR scandals. The new regulation is a codification of the International Organization of Securities Commissions' report – *The Principles for Financial Benchmarks* – which outlines the basic standards and frameworks for benchmarks used in financial markets.

The LME supports regulatory initiatives to curb manipulative behaviour regarding benchmarks, and to secure the robustness and reliability of these mechanisms.

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The definition of "benchmark" remains unclear and is still subject to discussion at the European level. It is not clear which of the LME's reference prices would meet the definition. However, the LME reference prices are already subject to intensive regulation and scrutiny through the LME's status as a Recognised Investment Exchange under the UK Financial Services & Markets Act 2000.

The LME's view is that it would be inappropriate, and possibly lead to regulatory conflict, for its reference prices to be subject to a "second layer" of regulation as benchmarks. Nevertheless, it seems highly likely that the legislation will oblige the LME and its members to maintain greater supervision and governance standards, much of which might be disproportionate to the activities undertaken and the risk of manipulation associated with them.

It seems highly likely that the legislation will oblige the LME and its members to maintain greater supervision and governance standards

Benchmark administrators will be required to introduce a number of checks to ensure the integrity of the data they receive. This will, in turn, subject market participants to greater regulatory scrutiny. Members trading on the LME, and using or contributing to its prices, may be required to introduce new governance procedures such as sign-off processes, record-keeping and internal policies governing benchmark use. This is likely to increase compliance costs and could lead to diminished participation in price-discovery processes, which would be detrimental to the market as a whole.

The EU Benchmark Regulation is extraterritorial and will restrict EU firms' use of benchmarks provided by entities in non-EU countries. While the EU rules do allow for equivalence of non-EU benchmarks, the multitude of different rules adopted by non-EU countries towards governing benchmarks could make equivalence with the EU more theoretical than practical for many jurisdictions. For example, if an end-user based in the EU purchases metal from a supplier based outside the EU, the Benchmark Regulation is likely to mean that the contract for purchase could only be priced according to, or hedged against, an EU index or price. This would put the EU purchaser at a disadvantage to a non-EU purchaser, who would be permitted to value the contract, or hedge against the risk, using any relevant price or index.

The result of this arbitrage is likely to lead to widespread market fragmentation and may have a material detrimental impact on the smooth functioning of the wider metals markets.

European Market Infrastructure Regulation

The European Market Infrastructure Regulation (EMIR) seeks to reduce systemic risk in markets by introducing derivatives reporting, clearing and risk-mitigation techniques for currently uncleared derivatives, including commodities. The rules apply to EU financial and non-financial institutions, and to non-EU entities entering into derivatives agreements with EU institutions.

Derivatives reporting, which applies to OTC and exchange-traded derivatives, was introduced in February 2014 and requires financial institutions and non-financial institutions such as corporates to report details of their derivatives trades to one of six trade repositories approved by the European Securities and Markets Authority.

EMIR also envisages requiring financial and non-financial institutions to clear their vanilla OTC trades through CCPs as part of the global regulators' G-20 mandate to reduce systemic risk in financial markets. Derivatives transactions traded bilaterally will be subject to tougher

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margining requirements and risk mitigation rules such as capital requirements, mark-to-market valuations, and having dispute resolution procedures in place.

The introduction of centralised clearing does bring about greater transparency and safety to the derivatives market. Having centralised clearing and derivatives trade reporting enables regulators to identify potential build-ups of systemic risk in the markets. CCPs help reduce risk, but with an increased focus on clearing, one could argue that risk has become concentrated and CCPs are now systemically important financial institutions (SIFIs).

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In order to clear through CCPs, clearing members (which will include commodity firms) are obliged to source and post high-grade collateral as margin. As of September 2015, LME Clear has received approval from the Bank of England to accept LME metals warrants as collateral, making it the first clearing house ever to be able to offer this facility. This initiative will allow market participants to post LME metals warrants, giving the LME market a new source of eligible collateral.

CCPs naturally implement rigorous risk management protocols given their systemic importance. LME Clear is an industry leader, and renowned for its robustness. While EMIR subjects CCPs to hold 25% “skin in the game” in the default waterfall, the LME Clear holds over and above that.

At the heart of EMIR lies client protection and the ability of a CCP to effectively port client collateral in the event of a clearing member failure. EMIR mandates the use of one of two types of CCP account structures, which are designed to segregate client positions and any margin that has been posted. The first is an “omnibus client segregation account”, which enables positions and margin of clearing members to be separate from those of their clients. The second is an “individually segregated account” which separates a client's positions and margin from those of other clients.

Each type of account has benefits, and the choice of structure by members will ultimately be determined by cost versus risk. Firms need to clearly understand the risks they are accepting with each account structure, especially in times of stressed market conditions.

EMIR is very recently implemented and the market has had to make some fairly seismic changes to accommodate it. However, EMIR is now already up for review. LME Clear believes that legislation of this size should be given the appropriate amount of time to bed in for the market to truly appreciate any potential pitfalls or gaps that require plugging. To this end, we have responded to the European Commission sharing our experiences of implementing EMIR to date.

So what lies ahead?

The impact of European regulatory changes should not be underestimated.

Commodity traders throughout the value chain, including those transacting in metals, must ensure compliance with the rules or they risk finding themselves on the wrong side of the regulatory line. The implementation dates of many of these rules are rapidly approaching, and market participants should be thinking about how they will become compliant.

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A number of these rules have yet to be finalised, and various specifics of the regulations are still under discussion. The LME is working with regulators to ensure that the cumulative effect these rules will have on the metal trading community are not underestimated. Our argument is that if the unique features of our industry are not taken into account they will increase both the potential risks and the cost of price discovery and hedging for many market participants. This will have the unintended consequence of fragmenting liquidity in the wholesale markets, ultimately leading to higher prices for consumers.

The implementation dates of many of these rules are rapidly approaching, and market participants should be thinking about how they will become compliant

The LME supports transparency, good conduct, the ability to manage risk and the reduction of systemic contagion. However, requiring the commodity markets to comply with regulation that is designed for other, completely different, asset classes may stifle the function of both price discovery and risk transfer. The FCA concurred in its Commodity Markets Information note in 2014 that regulations such as EMIR, MiFID II, MAR and Benchmarks have a wide market scope within which the treatment of commodities is not central.

Regulatory arbitrage is a core result of discrepancies between global regulations. Asia and the US will be the natural winners as market participants seek to conduct their business in more liquid markets with better prices than in the EU. Meanwhile, onerous requirements related to trading on exchange may result in the exact opposite of the regulators' initial aims to move transactions from the opaque, off-exchange trading environment into more transparent, regulated venues.

Regulators have come a long way in their aims to enhance financial regulation, support institutional reforms, increase global co-ordination, and improve the supervision of financial markets and entities. However, when they impose a one-size-fits-all type of regulation onto markets as unique and unusual as ours, we start to see new risks and dangers appear.

At the LME, we recognise our role within the metals industry and the responsibility we have to ensure we are ready and able to take on the new regulatory challenges ourselves, while also helping our members, clients and wider users to do the same.

Contact us

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