



## LONDON METAL EXCHANGE

16 February 2004

Mr Fabrice Demarigny  
Secretary General  
The Committee of European Securities Regulators  
11-13 avenue de Friedland  
75008 PARIS  
FRANCE

[secretariat@europesefesco.org](mailto:secretariat@europesefesco.org)

Dear Mr Demarigny,

### Call for Evidence: Provisional Mandate: Financial Instruments Markets Directive

#### General

The London Metal Exchange is a UK Recognised Investment Exchange that regulates the world's premier marketplace for the trading of exchange-traded forwards and options on non-ferrous base metals. There are no comparable regulated markets within the European Union. The only competitors to the LME operate in the United States, Japan, and China, and there is only one Multilateral Trading Facility (MTF) known to offer trading in base metals derivatives within the EU.

The membership of the LME comprises:

- investment firms that are credit institutions or affiliates of credit institutions;
- investment firms that are not credit institutions and which are parts of groups of companies, the main business of which is investment business;
- investment firms that are not credit institutions and which are parts of groups of companies, the main business of which is not investment business; and
- trade members that are not investment firms, but which produce, use, and buy and sell the physical metal that underlies base metals derivative contracts traded on the Exchange. These members also use the LME to hedge price risk and to buy and sell the physical metal.

Users of LME markets comprise knowledgeable, experienced, wholesale and professional clients that require little in the way of advice and guidance when using the markets of the Exchange, and, consequent to their daily participation in physical dealings or professional investment dealings, are fully aware of the supply and demand of metals, and, hence, prices.

Given the products traded, the nature of the membership of the Exchange, its user-base, and the absence of a similar market elsewhere in the EU, the LME believes that the decision to include base metals derivatives within the scope of the Financial Instruments Markets Directive (FIMD) leaves it uniquely placed within the EU to comment on and respond to the

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call for evidence made by CESR in response to the provisional mandate given to it by the European Commission.

### **General LME comments on the advice that CESR should provide**

As mentioned in the introduction to this letter, clients of the LME are knowledgeable, experienced, wholesale and professional, dealing in both the physical metals market and derivatives on the base metals. The EU Commission acknowledged that such users are a feature of commodity derivatives markets when, in the Explanatory Memorandum to the proposal for updating the Investment Services Directive (ISD), it wrote that the extension of the ISD to commodity derivatives business “must take account of certain features specific to trading in these instruments, as well as the predominantly ‘wholesale/professional’ nature of the market participants... Given their experience in trading in these instruments, Member States could classify some or all commodity traders as ‘eligible counterparties’ which are able to trade in the marketplace without requiring “conduct of business” protections.”

It is evident that the text of the FIMD failed to follow through by failing to differentiate between retail investors dabbling in securities markets and professionals managing business risk in commodity derivatives. Consequently, the LME believes that CESR should ensure that in drafting its advice on implementing measures its recommendations are appropriate and proportionate to the risks of investors using commodity derivatives, avoiding excessive detail due to the “wholesale/professional” in nature of such clients.

Given the above, the LME recommends that, as CESR did when calling for evidence in respect of the mandate for the Market Abuse Directive (MAD), CESR should extend an invitation to commodity derivatives markets to meet members of the Expert Groups and the Consultative Working Group considering the provisional mandate in respect of the FIMD to discuss issues specific to commodity derivatives markets. Following the 3 March 2003 meeting on MAD, CESR noted that it had found the discussions very helpful. We believe that a similar outcome will result from a meeting on FIMD issues.

### **LME comment on the priority issues included in the provisional mandate**

LME comments are restricted to those issues on which we have a view at the present time.

#### **Issue 3.1.1**

Given that the heading of this section is “compliance obligations and treatment of personal transactions”, we presume that CESR will not provide technical advice on possible implementing measures with respect to transactions by professional clients and eligible counterparties.

#### **Issue 3.1.5**

As noted in our opening remarks, the membership of the LME comprises investment firms that are both credit institutions (including affiliates of credit institutions) and investment firms that are not credit institutions. The LME recommends that in drafting its advice, CESR should seek to avoid advocating measures that could be anti-competitive, by making it more attractive for clients to trade through investment firms that are credit institutions than through investment firms that are not credit institutions.

In addition, the client base of members of commodity derivatives markets is wholesale and professional in nature. Accordingly, when considering advice to give to the Commission on the protection of client’s financial instruments and funds when a firm holds financial instruments and funds belonging to clients, the LME recommends that CESR should be neither prescriptive nor overly detailed with respect to the financial instruments and funds of professional clients or eligible counterparties. In particular, in drafting the advice it should take full account of prevailing accepted market practices in those few Member States where successful global commodity derivatives markets thrive, and which have, in certain cases, developed these practices over the course of 100 years or more. CESR should also take into account the knowledge and experience of professional investors, which we expand upon in the following section.

### **Issues 3.3 and 3.4**

As mentioned earlier, clients of investment firms that use commodity derivatives to hedge risk or to buy or sell physical commodities are wholesale/ professional users of the markets. The industrial users are very knowledgeable and experienced, and fully capable of assessing risk and reward when dealing in commodities and commodity derivatives. As with any other of their clients, industrial users undertake a credit assessment before choosing their broker. They commonly give discretion to their broker when giving orders to allow a degree of flexibility in order handling. Furthermore, such users generally operate through several investment firms in order that they can benefit from the strengths of different brokers in different fields – for example, some investment firms have better expertise in certain metals, others in far forward trading dates, or others in trading between different dates, that is, in spreads or carries, while others might be the ‘clearing broker’ of choice rather than an executing broker of choice.

While it is common in commodity derivatives markets for wholesale/ professional users to opt out of best execution requirements and other order handling rules, the FIMD requires all clients, irrespective of expertise, to receive protections appropriate to retail clients, unless they are permitted to opt to be treated as eligible counterparties.

The LME believes that it is both inappropriate and unnecessary for CESR to compound this situation by providing advice that results in professional clients being treated as though they are retail clients. This is particularly so if they would rather be treated as eligible counterparties but cannot because of FIMD pre-determined proportionate requirements, including quantitative thresholds, or because the status of the client is determined by the law or measures of the Member State in which the client is established.

### **Issue 3.3**

This issue concerns conduct of business obligations when providing investment advice to clients. The LME notes that the provisional mandate calls upon CESR to “define, where relevant, the exact content of each obligation laid down in Article 19”. Despite the wording of the mandate, the LME is surprised at the call for “exact” content. This seems to be overly restrictive, and the LME recommends that CESR revert to the Commission in advance of receiving the final mandate to seek to have the removal of the word “exact” as its inclusion will undoubtedly cause problems by its sheer inflexibility.

### **Issue 3.8**

With respect to the admission of financial instruments to trading, the Commission is to provide advice on different classes of instrument, which include commodity derivatives. The LME wishes CESR to note that commodity derivatives are quite unlike securities admitted to trading or derivatives on securities admitted to trading where the issuers of the underlying securities have disclosure obligations. That does not apply with respect to commodity derivatives, where the deliverable material, be it copper, nickel, aluminium, coffee, or cocoa, oil, electricity or gas, is likely to be produced globally, by numerous producers, and is, by and large, fungible. CESR might wish to arrange a meeting with commodity derivatives markets to discuss contract design and trading, including convergence, before drafting the advice.

The LME is not certain that it understands the meaning of the term “parallel trading” in the technical annex to the provisional mandate, where CESR is to analyse the case of ‘parallel markets’ with “respect to the obligation imposed upon regulated markets to make information accessible to their members or participants.” We believe that this refers to disclosure obligations on issuers of securities, but we should appreciate learning if this is correct.

**Contact details**

Should you or your colleagues wish to discuss the LME response, you can contact me by telephone (+44 (0)20 7264 5675), by fax (+44 (0)20 7264 5513), or by e-mail (neil.mcgeown@lme.com).

Yours sincerely

A handwritten signature in black ink, appearing to read 'Neil McGeown', with a stylized, cursive script.

Neil McGeown

LME Regulation & Compliance