Client Alert 07-029

Energy, Trade & Commodities

Market Abuse and the Commodities Markets

Introduction

The recent trends and significant developments in the commodities markets have not gone unnoticed by the United Kingdom's financial services watchdog. The growth of the commodities markets and the increasing investment by non-traditional market participants such as pension and hedge funds has come to the attention of the Financial Services Authority ("FSA"), which has shown growing concern over the risks and challenges faced by all stakeholders in these markets[1]. The FSA has indicated an increased degree of interest in the commodities markets and has signalled a shift in its approach towards regulating them.

FSA Concerns

The commodities markets have traditionally received less regulatory attention than other larger and more high profile markets such as the equity markets. This was, in part due to the specialised nature of commodity markets which, in the FSA's view, are by and large dominated by professional participants working to a presumption of caveat emptor. The FSA has also generally considered the commodity derivative markets to pose a lower risk than the equity markets because of the knowledge base of traditional market users. Recent developments and increasing activity in the commodities markets have, however, caused the FSA to identify areas of potential risk as regards to behaviour constituting market abuse. In particular, the FSA has flagged up the growing number of market participants and the changing nature of these participants as factors that are a cause for concern.

Regulation

Currently, the FSA does not have sector specific rules for the commodities and the commodities derivatives markets rather the FSA's regulation derives from several different regimes such as through its regulation of Recognised Bodies (Exchanges and Clearing Houses) and through its bespoke arrangements for the supervision of firms (particularly in the energy and oil markets). The FSA's regulatory remit in terms of combating market abuse derives from Part VIII of the Financial Services and Markets Act (2000) ("the FSMA") and the FSA's Code of Market Conduct (2001) ("the Code") provides guidance on this remit and on the market abuse regime in general.

Market Abuse

Although the FSA admits that there is no suggestion that commodities markets are any more susceptible to market abuse than any other, as a response to the developments within these markets, the FSA has pledged an overall increase in its monitoring efforts. In particular, the FSA has recently indicated that it will now target its resources at institutional market abuse.

The civil market abuse provisions in Part VIII of the FSMA incorporate the EU Market Abuse Directive and set out the provisions to penalise behaviour constituting "market abuse". The market abuse regime works in tandem with the FSA's other regulatory regimes such as those identified above and sits astride the criminal sanctions (i.e. insider dealing and market manipulation) available to the FSA, however it applies to a wider range of activities.

The definition of market abuse is very wide and can potentially be committed by almost anyone involved in investment activity. The offence itself is not dependent on the perpetrators intent or recklessness. Rather, it is judged on the effect of the relevant behaviour. Further because the regime is civil rather than criminal in nature the FSA must only prove a case to the civil standard. The small number of proceedings brought under the criminal insider dealing offences has been attributed by some commentators to the higher criminal burden of proof required for a criminal prosecution and this has led to the perception that the criminal regime is insufficiently flexible to properly deal with all forms of market misconduct.

[1]Growth in commodity investment: risks and challenges for commodity market participants, Emmet Doyle, Jonathan Hill, Ian Jack, FSA Infrastructure Department, March 2007.

If you have questions or would like additional information on the material covered in this Bulletin, please contact a member of our Energy Trade & Commodities Group:

Suzanne E. Bainbridge *(London)*
ddi: +44(0)20 7772 5911
sbainbridge@reedsmith.com

Paul M. Dillon *(London)*
ddi: +44(0)20 7772 5899
pdillon@reedsmith.com

Kyri Evagora *(London)*
ddi: +44(0)20 7772 5896
kevagora@reedsmith.com

Diane Galloway *(London)*
ddi: +44(0)20 7772 5911
dgalloway@reedsmith.com

Richard G. Swinburn *(London)*
ddi: +44(0)20 7772 5887
rswinburn@reedsmith.com

Marjorie Holmes *(London)*
ddi: +44(0)20 7816 3837
mholmes@reedsmith.com

Siân Fellows *(London)*
ddi: +44(0)20 7772 5806
sfellows@reedsmith.com

April 2007

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Definition of Market Abuse

Behaviour will, broadly speaking, constitute market abuse if it fulfils the following requirements:

- the behaviour (which can be both action or inaction) occurs in relation to qualifying investments traded on a prescribed market. This also applies to conduct relating to derivatives on those qualifying investments and conduct relating to instruments underlying exchange traded investments (i.e. commodities underlying exchange traded derivatives); and
- the behaviour is one of the following types:
    - insider dealing;
    - improper disclosure;
    - misuse of information;
    - manipulating transactions;
    - manipulating devices;
    - dissemination; and
    - misleading behaviour and distortion; and
- the behaviour must be likely to be regarded by a regular user (a reasonable person who regularly deals on the relevant market in investments of the kind in question) of that market, who is aware of the behaviour, as a failure on the part of the person or persons concerned to observe the standard of behaviour reasonably expected of a person in his or her position in relation to that market.

The Code provides guidance as to whether or not behaviour amounts to market abuse and outlines factors that, in the opinion of the FSA, are to be taken into account in determining market abuse. The Code applies to behaviour that occurs in relation to qualifying investments traded on the United Kingdom's "prescribed markets" which include the London Metal Exchange, the International Petroleum Exchange and LIFFE, as well as investments traded on other European regulated markets. The definition of qualifying investments is wide in scope and includes transferable securities, financial-futures contracts and derivatives on commodities.

It is important to note that the Code refers to an objectively acceptable standard and makes clear that behaviour which is accepted or tolerated by actual users of a market may not be considered acceptable by the hypothetical regular user. This may raise concern over some established market practices within the commodities markets. Failure to meet acceptable standards will also, however, take into account a person's position, experience, skill and standard of knowledge in relation to that market.

The FSA's regulation of over-the-counter ("OTC") commodity markets is governed by the operation of the Code. Although the Code applies only directly to qualifying investments admitted to trading on a prescribed market, if abusive behaviour in OTC markets affects an exchange market, then the FSA may be able to enforce relevant market abuse provisions against the parties to OTC trading.

Misleading behaviour and distortion

The seventh category of behaviour constituting market abuse is of particular importance in the context of physical commodity trading, we therefore expand below on this type of behaviour.

Misleading Behaviour

The test for this particular type of behaviour is whether it is likely to give a regular user of the market a false or misleading impression as to the supply of, demand for, or price or value of the investment of the kind in question. This provision is aimed at the prevention of artificial transactions and market activity which have the principal effect of artificially inflating or depressing the price of investments and thereby giving market users a false and misleading impression.

The Code provides two examples of this type of behaviour which are relevant to the trading of physical commodities; namely, the movement of physical commodity stocks; and/or the movement of an empty cargo ship, each of which might create a misleading impression as to the supply of, or demand for, or price of, a commodity or the deliverable into a commodity futures contract.

Distortion

This provision also aims to combat “market rigging” and although the Code does not define distortion, it states that behaviour will amount to distortion if it interferes with the proper operation of market forces with the purpose of positioning prices at a distorted level.

The Code identifies two examples of market distortion:

- an abusive squeeze: whereby a person with significant control over the supply and demand of a product engages in behaviour to corner the market with the aim of positioning the price of that product at a distorted level; and

- price positioning: entering into a series of transactions with the purpose of positioning the price at a distorted level set by the person entering into the transactions.

Although market squeezes occur relatively frequently when the proper interaction of supply and demand leads to market tightness there is some suggestion in some physical markets, such as the market for Brent crude oil that there may be some market participants engaging in “abusive squeezes”.

The recent example of the complaint by the International Wrought Copper Council to the European Commission, regarding the effect of the London Metals Exchange’s warehousing practices on the price of copper, highlights the risk of market distortion posed by certain established practices within commodities markets.

Safe harbours

The FSMA provides for limited statutory exemptions for types of behaviour that will not amount to market abuse which cover:

- behaviour that falls within the “safe harbour” provisions in the Code some of which are commodity market specific; and

- behaviour specifically required or permitted by the FSA’s rules (such as price stabilisation and Chinese walls).

Penalties

Penalties can be imposed not only on someone who has engaged in market abuse but also on someone who has required or encouraged another person to engage in market abuse.

The primary penalty the FSA has available to it if it is satisfied that market abuse has occurred is an unlimited financial penalty. Alternatively, the FSA may publish a public censure stating that a person has engaged in market abuse or has required or encouraged another person to do so. The FSA may also issue a private warning rather than proceed with formal enforcement if it thinks this appropriate.

The FSA may not impose a penalty on a person who has believed reasonably that their behaviour did not amount to market abuse, or took all reasonable precautions and exercised due diligence to avoid committing market abuse.

Chapter 14 of the FSA’s Enforcement Manual sets out the FSA’s statement of policy regarding the imposition and level of penalties as well as an indication of when the FSA will regard a person as benefiting from the “reasonable grounds” or “reasonable precaution” provisions.

Restitution Orders

An additional penalty available to the FSA is its ability under section 383 of FSMA to apply to the English High Court for a restitution order. In these circumstances the court may make such an order where it is satisfied that a person (“the Perpetrator”) has engaged in market abuse or has required or encouraged another person to engage in behaviour which would amount to market abuse if done by the Perpetrator. The court must be satisfied that the profits have accrued to Perpetrator (not anyone else) as a result, or that loss or other adverse effect has been suffered by other persons. “Adverse effect” has not been defined in the FSMA but there is a suggestion that restitution can be required even where the loss is not financial. The court has the discretion to determine the amount of restitution paid and any such restitution must be paid to those to whom the profits are attributable or those who suffered the loss or adverse effect.

Importantly, section 383 preserves the rights of parties other than the FSA to bring proceedings themselves for restitution thereby allowing investors to bring private actions alongside any action brought by the FSA.

Safeguards against Market Abuse

In light of the FSA's renewed approach toward the regulation of the commodities markets and the risk of significant penalties arising out of behaviour constituting market abuse, market participants must put in place effective measures to combat market abuse such as ensuring that:

- they have robust monitoring systems and controls;
- their compliance staff are appropriately experienced and skilled;
- their trading staff receive appropriate training and are aware of relevant reporting procedures; and
- they properly manage conflicts of interest.

By taking the appropriate steps market participants should minimise the risk of market abuse and ensure that they and their staff observe proper standards of market conduct.

Mifid

Commodities firms should be aware of the wide reaching implications of the EU Markets in Financial Instruments Directive (MiFid) which is set to be introduced as of 1 November 2007. MiFid will introduce a legislative regime that will govern certain firms that trade and deal in commodity derivative instruments and will significantly affect the manner in which the FSA regulates commodity markets. We will provide further updates and information on how MIFID may potentially affect your business in due course.