

CONSULTATION PAPER

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Transfer of Regulatory Oversight of Commodity Derivatives From IE to MAS

MAS

Monetary Authority of Singapore

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PREFACE

In February 2008, the regulation of commodity futures was transferred from the Commodity Trading Act (“CTA”) administered by the International Enterprise Singapore Board (“IE”) to the Securities and Futures Act (“SFA”) under the purview of the Monetary Authority of Singapore (“MAS”). Regulatory oversight of other commodity derivatives (i.e. commodity forwards, contracts for differences on commodities, leveraged commodity trading – herein referred to as “commodity derivatives”) and spot commodity trading remain with IE under the CTA.

2 IE and MAS propose to transfer the regulatory oversight of commodity derivatives under the CTA to the SFA. Following the global financial crisis, there have been steps taken internationally to strengthen the regulatory framework for OTC derivatives. MAS has announced its policy consultation on the regulation of OTC derivatives separately. Recognising the global trend towards strengthening regulations in OTC derivatives, the proposed transfer would provide better synergy and alignment of regulatory approach across the major classes of OTC derivatives, and provide greater clarity to industry participants on the regulatory approach between commodity derivatives and commodity futures.

3 IE and MAS invite interested parties to forward their views and comments on the issues outlined in this consultation paper. Written comments should be submitted to:

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10 Shenton Way
MAS Building
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4 IE and MAS request that all comments and feedback be submitted by **26 March 2012**. Please note that all submissions received may be made public unless confidentiality is specifically requested for the whole or part of the submissions.

1 INTRODUCTION

1.1 In 2008, MAS took over the regulation of commodity futures from IE, so that the regulation of all futures contracts would come under one regulator. This included the regulation of markets and clearing facilities for commodity futures as well as intermediaries trading in commodity futures.

1.2 The regulatory oversight of commodity derivatives and spot commodity trading was retained under the CTA. The CTA regulates three main areas relating to commodity derivatives - broking in commodity derivatives, market for commodity derivatives and clearing facilities for commodity derivatives.

1.3 Entities which engage in broking transactions in both commodity derivatives and commodity futures are dually licensed by IE and MAS. These entities hold a Commodity Broker licence under the CTA and Capital Markets Services (“CMS”) licence under the SFA. Entities operating a market listing commodity derivatives and commodity futures require authorisation under the CTA to establish a commodity market and authorisation under the SFA to be an approved exchange or recognised market operator. Similarly for entities operating a clearing facility involving commodity derivatives and commodity futures, approval may be required from both IE and MAS. These entities therefore have to comply with two sets of rules and regulations under the CTA and the SFA respectively.

2 REASONS FOR PROPOSED TRANSFER

2.1 Alignment of Regulatory Regime

2.1.1 The commodity derivatives sector has been growing and evolving over the years. The characteristics of increasingly standardised commodity derivatives are becoming similar to those of commodity futures. The blurring of the distinction between such commodity derivatives and commodity futures may give rise to instances where it is unclear whether a particular contract falls within the regulatory ambit of the CTA or the SFA.

2.1.2 To streamline licensing and compliance requirements, IE and MAS propose that regulatory oversight of commodity derivatives be transferred from IE under the CTA

to MAS under the SFA. Entities which engage in broking both commodity derivatives and commodity futures will only need a single CMS licence from MAS after the proposed changes are effected. Entities operating markets or clearing facilities for commodity derivatives and commodity futures will similarly only need to seek authorisation from MAS instead of two agencies. This will provide greater clarity and efficiency to the industry.

2.1.3 The current regulatory regime requires close coordination between IE and MAS on developments relating to the regulation of commodity derivatives and commodity futures. This may lead to lags in regulatory responses to market developments. Having a single agency with regulatory responsibility over both commodity derivatives and commodity futures will allow swifter regulatory responses to market developments and changes in international regulatory standards or practices, including those set out in section 2.2.

2.2 Meeting International Standards

2.2.1 Following the global financial crisis, the G20 committed to improve the regulation of the OTC derivative markets as part of a push toward strengthening the international financial regulatory system. The Financial Stability Board (“FSB”) subsequently published a report on implementing G20’s mandate. Various jurisdictions are proceeding with new regulations to tighten regulation of OTC derivatives.

2.2.2 To keep in line with international standards, MAS is proposing to expand the regulatory scope of the SFA to include derivative contracts¹ on the major asset classes of commodities, credit, equity, foreign exchange and interest rates. As the expansion will result in derivative contracts on commodities coming under the ambit of the SFA, there will be an overlap with the regulation of commodity derivatives which currently falls under the CTA. Therefore, this paper proposes for MAS to take over the regulatory oversight of commodity derivatives, which is a subset of derivative contracts.² This will provide better synergy and alignment of regulatory approach across the major classes of OTC derivatives. We are cognizant that due to the nature of the underlying products, commodity derivatives may have certain characteristics distinct from those of financial derivatives. Where appropriate, MAS will take into account these differences when

¹ Refer to Paragraphs 2.2 and 2.3 of the OTC Derivatives Consultation Paper.

² CTA only regulates broking, markets and clearing facilities related to certain commodity derivatives (i.e., commodity forwards, contracts for differences on commodities, and leveraged commodity trading). Derivative contracts on commodities will capture a wider scope including commodity options and swaps which are not regulated under the CTA.

considering the regulatory framework for OTC derivatives. Please refer to MAS' Consultation Paper on Regulation of OTC Derivatives ("OTC Derivatives Consultation") for more details on MAS' proposal.

3 PROPOSED SCOPE FOR THE TRANSFER

3.1 Scope of regulation under the SFA

3.1.1 In the OTC Derivatives Consultation, MAS proposes to expand the scope of the SFA to include regulation of OTC commodity derivatives markets, clearing facilities and intermediaries. To effect this, MAS intends to include "commodity" as one of the derivative asset classes that MAS proposes to regulate.

3.1.2 The current definition of "commodity" under the CTA includes all tangible commodities while intangible commodities may be included through prescription by way of regulations. No intangibles have been prescribed under the CTA to date. As the market for intangible commodity derivatives appears to be small as compared to tangible commodity derivatives, there is no pressing reason to expand the current regulatory reach to include intangible commodities at this point in time. Therefore, we propose to preserve the status quo, i.e. to regulate only derivatives contracts in respect of tangible commodities while retaining the power to bring intangible commodity derivatives contracts into the ambit of the SFA by way of prescription if necessary. We will continue to monitor market developments, and where necessary, regulate intangible commodity derivatives on a case-by-case basis.

3.1.3 We also propose to exclude physically-settled commodity forward contracts from the scope of regulation under the SFA as such contracts are commercial merchandising transactions which create enforceable obligations to make or take physical delivery. The exclusion of such contracts from regulation is consistent with the current approach of exempting physical players who trade in the commodity markets under the CTA that involves physical delivery of the commodity for business purposes.

Q1 We seek views on the scope of the proposed regulatory regime under the SFA.

3.2 Regulation of spot commodity trading

3.2.1 With the transfer of the regulatory oversight of commodity derivatives from the CTA to the SFA, the remaining regulatory scope of the CTA will be spot commodity trading. Currently, intermediaries in respect of spot commodity trading or those which manage funds in connection with spot commodity trading on behalf of customers may be licensed as spot commodity brokers or spot commodity pool operators³ under the CTA.

3.2.2 Regulatory oversight of spot commodity trading was added into the scope of the CTA in 2001. The objective then for licensing the dealing in such was to keep out bucket shops (which were defrauding the public) and not to place curbs on legitimate spot commodity broking (including ordinary retailing). To this end, entities which trade on their own accounts and do not solicit funds from members of the public are exempted from licensing as a spot commodity broker. We propose to maintain the objective of the CTA to protect the public.

Q2 We seek views on the proposal to maintain the objective of the CTA to protect the public.

Q3 We seek views on the current scope of the CTA regulatory oversight of spot commodity trading and its effectiveness in the protection of the public against bucket shops.

3.3 Regulation of markets

3.3.1 IE and MAS propose that the regulatory oversight of commodity derivatives market operators be transferred from the CTA to the SFA. Entities which intend to establish or operate derivatives markets will be included under the proposed expansion of the scope of the SFA to cover OTC derivatives. Such entities will be required to seek authorisation from MAS prior to establishment or operation. MAS' proposal is for the current two-tier regulatory regime under the SFA to be extended to entities which operate derivatives markets, including commodity derivatives markets; corporations

³ No spot commodity brokers or spot commodity pool operators are regulated under the CTA currently.

operating markets that are systemically-important will be regulated by MAS as approved exchanges (“AEs”), while corporations operating other markets will be regulated as recognised market operators (“RMOs”).

3.3.2 As AEs or RMOs, derivatives market operators, including commodity derivatives market operators, will be subject to the similar obligations applicable to other AEs or RMOs operating futures markets. These include –

- a) as far as is reasonably practicable, operating a fair, orderly and transparent market;
- b) managing any risks associated with its business and operations prudently;
- c) not acting contrary to the interests of the public, having particular regard to the interests of the investing public;
- d) having sufficient financial, human and system resources to –
 - I. operate a fair, orderly and transparent market;
 - II. meet contingencies or disasters; and
 - III. provide adequate security arrangements.

3.3.3 The regulatory framework for derivatives market operators is elaborated upon in the OTC Derivatives Consultation. Entities which are already in operation will be given an appropriate period to apply to MAS for authorisation. A commodity derivatives market operator outside Singapore which offers its services in Singapore may also come under the regulatory ambit of the SFA by way of Section 339 on extra-territoriality of the SFA, and thereby require authorisation from MAS.

Q4 We seek views on the proposal to transfer regulation of commodity derivatives market operators to the SFA and the extension of the existing two-tier regulatory regime to these operators.

3.4 Regulation of Clearing Facilities

3.4.1 A clearing house that clears and settles commodity contracts for a commodity market requires authorisation under the CTA prior to its establishment or operation. IE and MAS propose that the authorisation for such clearing houses be transferred from the CTA to the SFA. Further, MAS proposes that the definition of a commodity derivatives clearing house be aligned with the definition of a clearing facility under the

SFA, which would be expanded to include clearing facilities for derivative contracts. The proposed two-tier regulatory regime under the SFA as contained in the OTC Derivatives Consultation – Approved Clearing House (“ACH”) and Recognised Clearing House (“RCH”) – will be extended to such entities.

3.4.2 Under the proposed ACH regime, systemically-important clearing facilities will be regulated as approved clearing houses. In general, all clearing facilities performing the role of central counterparties will be considered to be systemically-important. An approved clearing house will be subject to the same rigorous standards applicable to existing designated clearing houses. All other clearing facilities will be recognised as RCHs. Such RCHs will be subject to a set of general obligations consistent with ensuring the safe and efficient operation of their clearing facilities.

3.4.3 We note that the current definition and provisions for clearing facilities under the CTA are scoped to be in support of commodity markets. Thus, a clearing facility will only be regulated if it is providing clearing and settlement for a regulated commodity market under the CTA. The transfer of regulatory oversight to the SFA will represent an expansion of regulatory scope to allow for regulation of clearing facilities for commodity derivatives. Following the transfer, operators of clearing facilities for commodity derivative contracts, regardless of whether the contract is executed on a regulated market, will require authorisation from MAS.

3.4.4 The regulatory framework for clearing facilities is elaborated upon in the OTC Derivatives Consultation. Entities which are already in operation will be given an appropriate period to apply to MAS for authorisation. A commodity derivatives clearing facility operating outside Singapore which offers its services in Singapore may also come under the regulatory ambit of the SFA by way of section 339 on extra-territoriality of the SFA, and thereby require authorisation from MAS.

Q5 We seek views on the proposal to transfer regulation of clearing facilities for commodity derivative contracts to MAS and the expansion of regulatory ambit after the transfer.

3.5 Regulation of Intermediaries

3.5.1 With the transfer of the regulatory oversight of commodity derivatives from the CTA to the SFA and the expansion of scope of the SFA to cover derivative contracts, intermediaries dealing in commodity derivative contracts will be required to hold a CMS licence under the SFA. These intermediaries include entities which are brokers or dealers in respect of commodity derivative contracts and entities which manage funds investing into commodity derivative contracts on behalf of customers. Some of these entities may currently be licensed as commodity brokers⁴ under the CTA. MAS' proposed approach to the licensing of intermediaries dealing in derivative contracts, including commodity derivative contracts, is set out in the OTC Derivatives Consultation.

3.5.2 As set out in the OTC Derivatives Consultation, MAS will adopt a strict licensing approach where only entities with an established track record and parentage, and which are reputable and financially strong will be granted a CMS licence. As a CMS licensee, the entity will have to comply with the relevant capital, business conduct and risk management requirements under the SFA.

3.5.3 Under the CTA, banks licensed under the Banking Act and merchant banks approved under the Monetary Authority of Singapore Act are exempted from holding the relevant licences for the conduct of commodity derivatives activities under the CTA. With the proposed transfer of the regulatory oversight of commodity derivatives to SFA, banks and merchant banks would be exempted from holding a CMS licence but would be required to comply with the applicable business conduct requirements under the SFA for dealing in derivative contracts, including commodity derivative contracts.

3.5.4 In addition, a representative of a CMS licensee or a bank who carries out regulated activities in respect of derivative contracts, including commodity derivative contracts, must be an Appointed Representative, and meet fit and proper, and other requirements under the SFA.

Q6 We seek views on the proposal to transfer regulation of intermediaries dealing in commodity derivatives to MAS.

⁴ No commodity pool operators are licensed under the CTA currently.

4 TIMELINE FOR TRANSFER

4.1 IE and MAS will take into account feedback to this consultation paper before finalising the proposed regulatory framework for commodity derivatives⁵ and commencing the legislative consultation on amendments to the CTA and the SFA. Subject to the feedback received on this consultation paper, the proposed transfer of regulatory oversight of commodity derivatives from IE under the CTA to MAS under the SFA is targeted for 4Q2012.

⁵ This will form part of the broader regulatory framework on OTC derivatives which will be finalised after taking into account the feedback to the OTC Derivatives Consultation.



Monetary Authority of Singapore

