FICC Markets Standards Board

Binary Options standard
for the Commodities markets

Final

November 2016

I Introduction

1. The FICC Markets Standards Board

The FICC Markets Standards Board ("FMSB") was established in 2015 in response to the Fair and Effective Markets Review in the UK with a mandate to issue Standards designed to improve conduct and raise standards in the wholesale Fixed Income, Commodity and Currency ("FICC") markets. The FMSB will work to build up a body of Standards over time, prioritising those areas where its Members consider there is a lack of clarity in the standards of behaviour expected of market participants, or a lack of understanding of the issues relevant to a product or transaction type, or evidence of poor conduct.

2. Applicability of FMSB Standards

Each FMSB member firm is expected to confirm annually that it is committed to conduct its FICC market activities (its "Activities") in a manner consistent with the Core Principles contained in FMSB Standards, and to have internal policies, procedures and controls reasonably designed to give effect to those Core Principles where they are applicable to its Activities, in a manner that is commensurate with the nature of its Activities in the relevant entity or jurisdiction. That confirmation is expected to apply to all FMSB Standards issued in final form in the calendar year prior to the year in which the confirmation is made.

The details of FMSB Member firms are available at http://www.fmsb.com.

Standards will be shared with Non-Member firms and their associations, who are encouraged to consider them and conduct their FICC market activities in a manner consistent with them. Information on Standards will be made available to users of the wholesale FICC markets (e.g. corporates and end investors) so that they may be made aware of their existence and FMSB expectation of market conduct.

3. Relationship with law and regulation

FMSB Standards do not impose legal or regulatory obligations on FMSB members, nor do they take the place of regulation.[1] In the event of any inconsistency, applicable law, rules and regulation will prevail. In developing Standards, relevant regulators will in many cases have commented on their drafting, alongside FMSB member firms and other bodies, such that the Standards once finalized and published are intended to represent an authoritative statement of global good practices and processes.

4. Relationship with other codes

Other codes already exist in relation to certain FICC markets, or are in the process of being produced. There will be some overlap between the work of the FMSB and such other bodies

[1] In March 2015 HMT proposed to change the Regulated Activities Order to bring binary options, including those on commodities, under Financial Services and Markets Act (FSMA) regulation in the UK (https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/418281/PU_1750_MiFID_II_26.03.15.pdf). This change is yet to come into force, and a precise date has not yet been announced by HMT. This follows the European Commission view that commodity binary options should be considered MIFID financial instruments (http://ec.europa.eu/yqol/index.cfm?fuseaction=question.show&questionId=1095)

and the FMSB will seek to ensure it adopts a consistent approach in cases of overlap wherever possible, and will seek to avoid issuing a Standard where the subject matter is already covered adequately by existing regulation or a code issued by another body. It may, however, draw attention to Members of an existing Code and request adoption, once appropriate steps have been taken to confirm its applicability.

5. Transparency Draft Standards

The FMSB issues “Transparency Drafts” of its proposed Standards in order to enable all FMSB members and other interested parties to comment on the proposed Standard. The normal period for comment will be indicated on the date of publication of the Transparency Draft. In the case of this Standard, this was between 22 July and 14 October, 2016.

II Commodity Binary Options

1. Explanation

This Standard aims to describe the characteristics of a type of transaction which is used by participants in the Commodities markets and which this Standard terms a *Commodity Binary Option* and to set out certain expected behaviours of wholesale market participants that enter into them.

2. Scope and applicability

This Standard applies to wholesale Commodities market participants, including banks, dealers, investment managers, non-bank liquidity providers, hedge funds, corporates, trading houses, inter dealer brokers, and market infrastructure providers active in the Commodities markets.

This Standard applies only to the product and market described in section 3 below. As noted there, many commodity binary options can be substantially replicated using vanilla structures and it is intended that this Standard also apply to such structures where they exhibit the characteristics of a commodity binary option.

This Standard has been developed for situations where intermediaries (e.g. banks/dealers) provide the defined commodity binary options products to third-party clients. Firms may, at their discretion, choose to apply this Standard to intra-group transactions in these products.

In this Standard the provider of the option is described as the *"Dealer"*, and the receiver of the option as the *"Client"*.

3. Description and definition – Commodity Binary Option

Commodity binary options, also known as barrier or digital options, are a class of option that are either activated or cancelled when a pre-determined level of a reference price is reached at a specified date or time (or during a specified date or time range).

Commodity binary options can be standalone options contracts or can be embedded in other options or structured products (such as "one-touch" or "knock-in", amongst others).

Commodity binary options can be discrete, having two potential values - a fixed pay-out if the Client is in the money or no pay-out if the Client is out of the money. In these cases, the payoff structure can be replicated through vanilla products such as call or put spreads with high notionals and very close strike prices.

Commodity binary options can also be continuous, triggering (i.e. knocking-in or knocking-out) at any point over the term of the option, either into a fixed payoff (positive or negative) or into another market risk instrument (i.e. another option).

4. Rationale for Commodity Binary Options

Commodity binary options are typically used by market participants to express a view about future price movements or to hedge bespoke financial risks. They are often seen as lower cost alternatives to "plain vanilla" options since they generally provide limited or contingent protection and are therefore an efficient way to hedge identified risk or express specific views on a market.

Commodity binary options are predominantly OTC products. They are used by a variety of wholesale market participants, including non-financial companies managing risk. They are also a component of a wider range of other complex structured products.

5. Trading models – Principal and Agent

Dealers providing commodity binary options may act either as a Principal or an Agent. Most of the risks and commercial conflicts of interest between the Dealer and the Client explained below only arise where the Dealer acts as Principal. Accordingly the more detailed requirements set out in section IV below apply only where the Dealer acts as Principal in the provision of the commodity binary option, whereas the Overarching Principles set out in Section III apply to all market participants regardless of the capacity in which the Dealer acts or the role of the parties.

6. Commodity Binary Option transactions

This Standard does not use the term "order" to describe a commodity binary option[2]. In FICC markets this term is often used to describe a request from a Client that a Dealer *attempt* to transact if certain conditions are met. A commodity binary option is rather a binding contract from the time its terms are agreed.

7. Risks of Commodity Binary Options

Unlike many vanilla options, binary options have the potential for a discontinuous pay-off profile (or a discontinuous change in present value). This means that their value increases or decreases as a step function when the reference price breaches a specified ("strike") level. Many barrier events exhibit no step change in value. Discontinuities tend only to occur at or near option expiry (or at the end of a barrier window). Wherever a discontinuity exists it creates a commercial conflict between the buyer and the seller of the option each who stand to gain or lose substantial/discontinuous amounts depending on small movements in price. That characteristic means commodity binary options create particular challenges which this Standard seeks to describe and address.

[2] It is noted that in certain circumstances national laws may define orders and that consequential obligations may arise.

III Over-arching Principles[3] for Commodity Binary Options

Core Principle 1: *Dealers that offer commodity binary options should adopt clear policies, controls and practices that strive for a fair and transparent outcome for Clients and ensure the inherent commercial conflict of interest created by commodity binary options is suitably managed or avoided.*

Commodity binary options give rise to a commercial conflict of interest between the counterparties to the option which last until (and at) expiry of the option. Firms transacting in these products should ensure such conflict is suitably managed or avoided. Firms offering products in a Principal capacity should take particular care where they have or are perceived to have the ability to affect the option underlying reference price.

Core Principle 2: *The hedging of bona fide risk positions by market participants is permissible.*

Core Principle 3: *Market participants who are parties to a commodity binary option should not trade in underlying financial Instruments, spot commodities or indices for the purpose of affecting the reference price of the option and thereby triggering or avoiding triggering the commodity binary option, a practise known as "defending" or "triggering".*[4]

Hedging exposure to a discontinuous payoff, mitigating genuine risk on either a transactional or portfolio basis, may be undertaken. That hedging activity may not, however, be undertaken in a way that moves the price to an artificial level or for the purpose of triggering or avoiding triggering a commodity binary option. This can be particularly challenging as an option approaches the strike[5], as large notionals are required to hedge risk, which could impact the reference price.

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[3] Principles are higher level than the Guidelines and focus on outcomes or intent. They endeavour to provide a reference where judgment is required in decision-making. It is recognised that these judgements cannot always be fully evidenced.

[4] Activity that gives a misleading signal as to the supply or demand of financial instruments, whether intentional or not, can amount to unlawful conduct, including market manipulation. Under the Market Abuse Regulation applying from July 2016, the scope of market manipulation is extended to behaviour concerning financial instruments traded on all trading venues (that is Multilateral Trading Facilities and Organised Trading Facilities), in addition to the Regulated Markets covered prior to July 2016. It is also broadened to include other financial instruments whose price depends on or has an effect on financial instruments traded on any trading venue (and not simply Regulated Markets), as well as covering certain spot commodity contracts and behaviour relating to benchmarks.

[5] When the reference price is near the strike price of the option, there may exist the incentive for both the option buyer and the option seller to place large order in the underlying asset in an attempt to move the market and thereby to prevent or cause the barrier event to be triggered.

Core Principle 4: *In determining whether the option has been triggered, the Dealer should act reasonably, in good faith and in accordance with the terms agreed with the Client.*

Core Principle 5: *Dealers should ensure that the Client is aware of the key mechanics of commodity binary options, in particular the fact that their nature gives rise to particular commercial conflicts of interest, and that the Dealer's hedging activity might affect the reference price of the option, by making clear in its terms of business or otherwise by disclosure to the Client that the Dealer observes FMSB Standards, or by express disclosure in some other way.*

IV Guidelines for Commodity Binary Options

Core Principle 6: *No market participant should enter into commodity binary options for the purpose of disrupting the market. All market participants should decline to transact commodity binary options where, at the time of entering into the commodity binary option, they reasonably consider these may have the effect of disrupting the market.*

Core Principle 7: *All participants that enter into commodity binary options should adopt appropriate and clear Conflicts of Interest policies, specifically addressing conflicts of interest arising as a result of potential market impacting hedging activity.*

Where possible measures should be taken either to eliminate conflicts or manage them so as to ensure the fair treatment of Clients.

Conflicts of interest disclosure to Clients should specifically note that hedging/risk management transactions may be executed close to an option trigger level and that the transaction may impact the reference price (and potentially result in an option being triggered or not).

Core Principle 8: *Market participants that are contributors – for example through contributions or transactions – to a benchmark setting mechanism (Benchmark Participants) should not make contributions for the purpose of affecting any commodity binary option transaction that references the benchmark to which they contribute.*[6]

Where a commodity binary option references a benchmark and the option counterparty is a Benchmark Participant, the potential for actual or perceived conflicts of interest exists. Institutions should seek to remove or manage these conflicts via robust organisational, governance, surveillance and administrative arrangements. These arrangements should identify, address and mitigate conflicts; including establishing controls to manage conflicts between participation in the benchmark setting and execution of the options and hedges. Appropriate and clear Conflicts of Interest policies should be in place to specifically address the conflict of interest of participating in a benchmark process and trading in commodity binary options that reference that benchmark.

Core Principle 9: *The terms agreed for any commodity binary option should be clear and properly recorded.*

All parameters required to fully define the terms of a commodity binary option should be agreed to and disclosed in writing by the parties and Dealers should in particular ensure there is clarity around the triggering mechanism. The mechanism used to decide whether or not the option has been triggered should be clearly documented. Should either party desire the right to use discretion in determining whether the option has been triggered, it should be agreed in advance including a dispute resolution mechanism.

[6] Any input to a benchmark that the person inputting knows or ought to have known to be false or misleading, whether intentional or not, can amount to unlawful conduct, including market manipulation.

***Core Principle 10:** Information on existing and prospective commodity binary options underlying financial details should only be disclosed or accessible to individuals beyond the desk(s) responsible for managing and executing the transactions on a strictly need-to-know basis.*

Client confidentiality requires that transactional details should not be disclosed to other firms. Sales desks should not have access to information on commodity binary options details other than those of their own Clients, unless on a need-to-know basis.

Information regarding a commodity binary option (whether pending or executed) or its associated hedging must be treated as confidential and must not be disclosed externally. This Standard does not, however, prevent Dealers from satisfying reporting requirements, disclosing details of a commodity binary option to the extent necessary for execution, transfer or settlement of that commodity binary option or from distributing appropriately aggregated and anonymised market colour provided such distribution does not negatively impact their Client's commodity binary options. In a situation where a Client is seeking input from an intermediary related to management of their risk position and hedges, this information should not be shared with other Clients.

***Core Principle 11:** Dealers should have clear policies on recording and retaining details of commodity binary options entered into with Clients, and associated hedging transactions, where identifiable.*

Dealers' booking practices and procedures for commodity binary options should be robust. Dealers providing commodity binary options in a Principal capacity should ensure the presence of appropriate pricing models, booking systems and procedures governing, amongst other matters, inception and maturity, risk oversight and model and input validation.

Specific policies should be in place providing guidance for Dealers executing commodity binary options regarding trader oversight; how they should be supervised; how their market conduct should be monitored; and what records of transactions need to be retained. Firms should be able to evidence that robust post-trade scrutiny of hedging activity relating to commodity binary options occurred in instances where the barrier level has been breached or closely approached.

***Core Principle 12:** Dealers should ensure that their personnel have been trained on the substance of this Standard.*

Dealers should ensure that they have appropriate staff training programmes in place, designed to ensure that all traders of commodity binary options understand the relevant systems and controls in place, the potential conflicts of interest inherent in the product and the behaviours expected of them. Managers or supervisors should also receive suitable training.