LEGAL UPDATE
FINANCIAL SERVICES REGULATION

Changes to the Regulation of Physical Commodity Forwards and Intangible Commodities: Securities and Futures (Amendment) Act 2017

Background

The Securities and Futures (Amendment) Act 2017 (the "**SFA 2017**") was passed by Parliament in January 2017 and will be operationalised by 2018.[1]

One of the aims of the SFA 2017 is to strengthen the regulation of the over-the-counter ("**OTC**") derivatives markets in light of the 2008 global financial crisis.[2] In furtherance of this aim, operationalisation of the SFA 2017 will lead to the transfer of the regulatory framework of OTC derivatives from the Commodity Trading Act (Cap 48A, 2009 Rev Ed) ("**CTA**"), administered by International Enterprise Singapore ("**IE**"), to the Securities and Futures Act (Cap 289, 2006 Rev Ed) ("**SFA**") under the purview of the Monetary Authority of Singapore ("**MAS**"). This transfer would allow MAS to implement policy proposals aimed at ensuring that the capital markets regulatory framework in Singapore keeps pace with market developments and is aligned to international standards and best practices.[3]

However, the transfer of regulatory authority has left some doubt as to how particular commodity products which were regulated in the CTA would be regulated, when the SFA 2017 comes into operation. This update will focus on 1) the regulation of physical commodity forwards; and 2) the regulation of intangible commodities and tangible commodities, once the SFA 2017 comes into operation.

Commercial Aspects of Physical Commodity Forwards

A forward contract is a private agreement between two parties, a buyer and a seller. The buyer agrees to buy an underlying asset at a price specified at the time of purchase. The delivery of the asset occurs on a future date as set out in the contract.

A physical commodity forward contract ("**Physical Commodity Forward**") is a forward contract where the underlying asset is a physical commodity. Examples of physical commodities include metals such as copper, silver and gold and agricultural products such as cocoa and wheat. Physical Commodity Forwards are traded OTC and the terms can be customized to fit the needs of the buyer and the seller.

Producers or traders of physical commodities such as grain, coffee or metals may choose to trade by way of Physical Commodity Forwards to stabilize their revenues or costs of their business operations. The general mechanism for producers or traders to stabilize their cost by way of a forward contract is as follows: a producer or trader holds a certain commodity, to insure against adverse price movements he sells the same amount of that commodity in the forward market at the negotiated price. When the forward contract matures, the producer or trader sells the commodity at the specified price. By doing so, they can avoid the risk of a price decline in the intervening period.

The regulation of Physical Commodity Forwards in the SFA 2017

Although the definition of a "forward contract" will be deleted from the SFA once the SFA 2017 is operationalised, Physical Commodity

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[1] MAS, *Consultation Paper II on Draft Regulations Pursuant to the Securities and Futures Act (P010 – 2017)* (26 May 2017) at para 3.3.
[2] "Explanatory Brief: Securities and Futures (Amendment) Bill 2016", http://www.mas.gov.sg/News-and-Publications/Speeches-and-Monetary-Policy-Statements/Speeches/2016/Explanatory-Brief-Securities-and-Futures-Amendment-Bill-2016.aspx.
[3] *Ibid*.

Forwards will be considered "derivatives contracts" as defined in the SFA 2017.

"Derivatives contract" is defined in Section 3(q) in the SFA 2017 as:

> (a) any contract or arrangement under which —(i) a party to the contract or arrangement is required to, or may be required to, discharge all or any of its obligations under the contract or arrangement at some future time; and (ii) the value of the contract or arrangement is determined (whether directly or indirectly, or whether wholly or in part) by reference to, is derived from, or varies by reference to, either of the following: (A) the value or amount of one or more underlying things; (B) fluctuations in the values or amounts of one or more underlying things; or (b) any contract or arrangement that is, or that belongs to a class of contracts or arrangements that is, prescribed to be a derivatives contract, but does not include — (i) securities; (ii) any unit in a collective investment scheme; (iii) a spot contract; …

The inclusion of "derivatives contract" to the definition of "capital markets products" set out in the SFA 2017 also operates to provide the MAS with wholesale regulatory authority over derivatives.

However, it is worth noting that, "physically-settled commodity forward contracts (including certain contracts with some form of optionality or embedded derivative) where the contracts are carried out with commercial purposes" will be excluded via the implementation of regulations which have yet to be published by MAS or consulted upon.[4] MAS has also stated that "the exclusion of such contracts will be set out in Regulations, on which comments will be sought at a later date."[5]

When the SFA 2017 is operationalised, we are of the view that:

1. Physical Commodity Forwards are included in the definition of "derivatives contracts" in the SFA;
2. "Derivatives contracts" will be, pursuant to its inclusion as "capital markets products", wholly regulated by the MAS under the SFA; and
3. "Physically settled commodities forward contracts" will be excluded or exempted from the SFA through Regulations (the new definition of "derivatives contract" allows MAS to prescribe contracts which are not "derivatives contracts").

The regulation of intangible commodities in the SFA 2017

Apart from tangible commodities such as oil and gold, intangible goods such as, rights relating to weather conditions and interest rates can be tradeable commodities.

As with Physical Commodity Forwards, intangible products allow businesses to hedge risk. Taking weather as an example, changes in weather affect businesses (e.g. agricultural products producers affected by a dry summer). Businesses may hedge against potential losses by trading weather derivatives. Based on a weather index, weather derivatives have a value ascribed to them on which a pay-out can be based.

At present, before the SFA 2017 comes into operation, regulatory oversight of commodity

[4] MAS, *Response to Feedback on Consultation Paper on the Transfer of Regulatory Oversight of Commodity Derivatives from IE to MAS (P004-2012)* (11 February 2015) at para 2.3.

[5] MAS, *2015 Consultation Paper on Proposed Amendments to the Securities and Futures Act (P004-2015)* (February 2015) at para 3.3.

derivatives such as commodity forwards, contracts for differences on commodities, leveraged commodity trading and spot commodity trading lies with IE under the CTA.[6] Within these classes of commodity derivatives, a further distinction is drawn between tangible and intangible commodities.

The Consultation Paper on the Transfer of Regulatory Oversight of Commodity Futures from IE to MAS dated November 2006 issued by IE and MAS (the "**2006 Consultation Paper**") sets out the approach adopted by IE in regulating intangible commodities. Paragraph 1.3.1 of the 2006 Consultation Paper states that, "the definition of 'commodity' includes all tangible commodities, *while intangible commodities (e.g. freight derivatives, weather derivatives, etc.) may be included by way of regulations*. No intangibles have been prescribed by the IE under the CTA (emphasis added)."

The 2006 Consultation Paper also states that, "[a]fter the transfer of regulatory oversight of commodity futures to MAS, the intention is to preserve the status quo under the CTA i.e. at the outset, futures contracts on tangible commodities would be brought within the ambit of the SFA and FAA [Financial Advisers Act (Cap 110, 2007 Rev Ed)], while intangible commodities may be prescribed as 'future contracts' under the SFA and FAA as necessary and appropriate on a case-by-case basis."[7]

The definition of "commodity" in the SFA 2017 is:

> (a) any produce, item, goods or article; (b) any index, right or interest in any produce, item, goods or article; or (c) any index, right, interest, tangible property or *intangible property* of any nature that is, or belongs to a class of indices, rights, interests, tangible properties *or intangible properties that is, prescribed for the purposes of this definition*, … (emphasis added) (Section 3(l)(c)).

Hence, it is likely that MAS will adopt an approach similar to IE's present approach with regard to the regulation of intangible commodities. That is to say, in order for an intangible commodity to come within the definition of "commodity" under the SFA 2017, it would need to be prescribed by MAS.

The definitions of "derivatives contract" (Section 3(q)) and "futures contract" (Section 3(v)) in the SFA 2017 also include intangible commodities by virtue of incorporating an "underlying thing" within their respective definitions. A "derivatives contract" is defined as a contract or arrangement, the value of which is determined by, referenced to, derived from or varies by reference to the value or amount of one or more "underlying things" or fluctuations in the values or amounts of one or more "underlying things". The SFA 2017 states that, an "underlying thing" in relation to a derivatives contract includes intangible property that belongs to a class of intangible property that is prescribed by regulations made under Section 341 to be an underlying thing in relation to a derivatives contract (Section 3(zr)(v)).

A "futures contract" is defined as an exchange-traded "derivatives contract" under the SFA 2017.

In light of the above, we are of the view that the regulation of tangible and intangible commodities is as follows:

1. Until the SFA 2017 comes into operation, IE has regulatory oversight over tangible and intangible commodities. However, IE

[6] "Get information on Singapore's Commodity Trading Act", https://www.iesingapore.gov.sg/E-Services/Commodity-Trading-Act/CTA-Overview.

[7] IE and MAS, *The Consultation Paper on the Transfer of Regulatory Oversight of Commodity Futures from IE to MAS* (29 November 2006) at para 131.

has not chosen to regulate any intangibles by way of subsidiary legislation.

2. When the SFA 2017 comes into operation, regulatory jurisdiction for both tangibles and intangible commodities is transferred to the MAS through the SFA 2017 as the definition of "commodities" in the SFA 2017 includes intangible commodities.

3. Further, the new definitions of "derivatives contract" and "futures contract" as set out in the SFA 2017 include intangibles and "derivatives contract" is included in the new definition of "capital markets product".

Commercial implications

Businesses which engage in the trading of Physical Commodity Forwards should take note that once the SFA 2017 is operationalised, apart from physically-settled forward contracts or other contracts exempted or excluded by MAS, forward contracts will come under the regulatory ambit of the SFA.

While IE has chosen not to regulate the trading of intangible commodities for the present period (i.e. before the SFA 2017 is operationalised), this may change once the SFA 2017 is operationalised. However, it remains to be seen what intangible commodities would be excluded by the MAS by way of regulation.

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