

Improving the transparency and stability of commodities markets



This document was drafted by Eurofi with input from its members. It does not engage in any case the French Presidency of the G20 or the French financial authorities.

Main document

1. The financial dimension of commodity markets has grown over the years making them an easily accessible asset class

Commodity markets cover a wide range of raw materials (agricultural, metal and energy commodities, emission allowances), that have quite different characteristics (in terms of size, supply, demand, inventory, storage ...). Among the largest and most liquid markets are oil and oil products, gold, copper, aluminum, wheat, electricity...

Financial commodities markets include forward or futures contracts, swaps and options and have developed alongside spot physical markets. They are essential to hedging the positions of industrial and financial players (against price increases or decreases of underlying physical commodities). These markets have developed, providing liquidity for participants and investors. Many of these contracts are exchanged OTC (OTC is estimated to represent around 50 and up to 75% of the overall commodities derivatives market¹). Commodity contracts are also traded on specialized exchanges mainly based in the US and in the UK² which centralize transactions and provide price transparency (eg CME / NYMEX, ICE, NASDAQ OMX, LME, NYSE LIFFE...).

The volume in transactions of financial commodities markets has strongly increased in the recent years, particularly through OTC trades, however after a peak in 2008, volumes have gone down significantly. According to BIS statistics, the notional value of OTC derivatives commodities was multiplied by 10 between June 2004 and June 2008 (growing from 1,3 Tio \$ to 13,2 Tio \$) and has doubled between June 2006 and June 2008 then went down to 2,9 Tio \$ in December 2009³. During the same period the notional value of the total market for OTC derivatives expanded from 220 Tio \$ in June 2004 to 683 Tio \$ in June 2008 then slightly decreased to 614 Tio \$ at the end of 2009, meaning that the share of commodities in overall OTC derivatives has grown.

The notional value of commodities derivatives strongly exceeds the underlying physical market also according to BIS statistics (the size of the financial market for oil is estimated to be 30 to 35x the underlying physical market for example, the same approximately for copper). This can be explained by the fact that the derivatives markets enable participants to gain exposure to the commodities markets in question, for hedging or other purposes, without needing to invest in the physical commodity which can give rise to delivery or storage costs. These statistics are however disputed by some experts who consider that the financial multipliers are much lower in some cases particularly for oil⁴.

¹ Although the lack of comprehensive data introduces a strong element of uncertainty. The BIS quotes a figure of up to 90% of swaps and options in oil being traded OTC (Source Quarterly review 2007)

² Other exchanges are based for example in China (SME), Japan (TOCOM), Latin America, India, Nordics

³ Source: BIS OTC derivatives market activity - Many different financial instruments exist: units in long only index funds, OTC swap agreements, ETFs, structured products...

⁴ Different issues are put forward regarding the way BIS data is calculated: eg the BIS calculates data for OTC and listed derivatives in different ways (OTC derivative data calculated according to the value of outstanding transactions, whereas listed commodity data calculated according to notional volume), the netting of long and short transactions which amount to zero is not accounted for...

There has been an increased participation of financial players, such as index funds and hedge funds, over the last years in commodities markets⁵ (compared to commercial companies) considered to have become increasingly “financialized”. Financial investors operate both in the derivatives markets and in the underlying spot markets (eg by buying commodities and building inventory)⁶. The development of index funds in particular has contributed to make commodities an easily accessible asset class with funds often investing in a diversified portfolio of commodity futures (eg the S&P GSCI Index)⁷ and many believe it has generally led to increased liquidity in these markets and facilitated hedging.

Many industry players however point out that the different approaches to commodities markets used by financial players should be taken into account. For example index investors and hedge funds which represent roughly the same proportion of trade volumes⁸ operate in quite different ways in these markets.

Hedge funds⁹ are generally active investors who enter the market, either long or short, when they perceive an opportunity. They may use some leverage and their positions are both physical and financial.

Index investors on the contrary are usually considered to be passive investors who use no leverage. They have a longer term focus and take financial positions. Although some investors in index funds have no specific expertise of the underlying physical markets and bet on the evolutions of the markets (eg individual investors), many of them are institutions such as pensions/sovereign wealth funds that allocate a certain percentage of their investible assets to the commodity asset class after thorough analyses. This has meaningful implications for the potential impact of these investors in the market. First, as mainly passive investors they are not likely to have a strong impact on volatility. Second, because they are investing on a percentage of assets basis, their objective is to sell when prices go up and buy when prices go down resulting normally in a dampening effect¹⁰. Finally unleveraged traders are less prone to suddenly liquidate positions and therefore less likely to contribute to destabilizing the market in case of downturn.

In the US, the development of the financial derivatives market was facilitated by a deregulation movement in particular with the Commodities Futures Modernization Act (CFMA) of 2000 which eliminated legal uncertainty as to the treatment of over-the-counter derivatives under US law. Separately, the CFTC, promulgated a wider interpretation of “bona fide” hedge rules applying to investors with positions to hedge physical transactions¹¹. The CFTC which had initially established federal position limits in the agricultural markets entrusted the

⁵ Compared to commercial companies. This is confirmed for example by the BIS in its Quarterly Review March 2007 “Financial investors and commodity markets”

⁶ Most future or forward contracts are terminated before their maturity and do not involve the actual delivery of physical commodities which enables financial players to take positions on this market without building inventory

⁷ Some sources consider that index fund investment in commodity markets increased from 90 Bio \$ at the beginning of 2006 to peak at just under 200 Bio \$ at the end of 2007 – source published by the OECD and provided by Barclays Capital

⁸ For example the report prepared by Professor JP Chevalier on oil price volatility mentions a share of 23% of open positions in 2008 for hedge funds and 28% for index funds

⁹ The number of hedge funds active in the commodities market is estimated by the BIS to have tripled between 2004 and 2006 and their commissions were considered to represent around 30% of OTC trading on the ICE in 2006.

¹⁰ The CFTC September 2008 study substantiated that index investors were net sellers (on an actual or notional basis) of energy commodities at the time that the price of oil ran up to \$147/bbl.

Finally, the introduction of these investors into the commodities markets was a means of offsetting the natural imbalance that exists where the producers of commodities tend to sell forward while the consumers of commodities (who are less organized and for whom commodity prices are less central) tend not to buy forward.

¹¹ Initially were only exempted from limits the positions intended to hedge physical transactions. Exemptions were extended to hedging “paper” positions taken by swap dealers in the OTC financial markets

exchanges themselves with making their own rules in some cases. The CFMA opened the way to all markets to set position accountability levels without prior consent from the CFTC.

2. Commodities markets have experienced strong price increases and volatility since 2006, which has led the G20 to require to “improve the regulation, functioning and transparency of financial and commodities markets”

2.1. These evolutions can be explained in many cases by physical and economic factors, although the lack of comprehensive data on physical and financial markets introduces a strong element of uncertainty

The levels of volatility experienced since 2006 are not unprecedented but some of the prices reached had not been observed since the 70's and volatility has been observed in many markets¹². Moreover very short term volatility (day-to-day or intraday) in some markets (eg WTI crude oil quoted on the NYMEX) appears to have been stronger between 2006 and 2008 than in previous periods according to some economic reports¹³. Sharp swings have been observed again in 2009 and 2010.

Increasing correlations have also been observed between the different commodities markets and between commodity derivative markets and other asset classes such as equities and financial derivatives markets.

Physical factors or market events have been pointed out by many economists as the main explanations of these price movements:

- The price of agricultural commodities such as corn, soybeans, wheat or rice grew at rates comprised between + 120% and + 175% between January 2006 and April 2008, before strong decreases during the second semester. This was mainly explained by increases in demand in developing countries, the impact of the diversification into biofuel production¹⁴ and stagnating productivity in many regions, as well as bad weather conditions and export restrictions. Increases in the cost of oil, the dismantling of public policies to support prices (such as the CAP in Europe which guaranteed prices) further explain this. In a similar way the decrease of prices at the end of 2008 can be mainly explained by increased supply, improved weather conditions and the lifting of export restrictions.

- The same type of evolution was observed in the oil market: after relatively stable prices between 2000 and 2003 due to the decision by OPEC to reduce production quantities (22 – 28 \$ a barrel), prices strongly increased between 2004 and 2008 reaching 100 \$ a barrel at the end of 2007, then prices rose to 145 \$ mid-2008 before dropping to 36 \$ at the end of 2008 and rising again to 80 \$ a barrel at the end of 2009. These increases can mainly be explained by an explosion in world demand particularly in developing countries (China, India, Brazil) and in parallel by reduced production in a certain number of countries (Venezuela, Iraq, Nigeria) as well as a sharp drop of OPEC countries' spare capacity. However, unlike for

¹² Exceptional volatility is however not generalized across markets since for example ICE Brent and ICE Gasoil statistics show levels of month volatility between 2006 and 2010 in line or just above previous years and lower than during previous crises

¹³ According to the Chevalier Report on oil price volatility commissioned by the French Finance Ministry

¹⁴ Ethanol is used as a biofuel additive for gasoline. World ethanol production for transport fuel tripled between 2000 and 2007 from 17 billion to more than 52 billion litres. The use of 10% ethanol gasoline is mandated in some U.S. states and cities. This caused a spike in corn prices and other agricultural commodities when land used to raise other commodities was converted to corn production.

previous high volatility episodes, there were no major structural transformations or geopolitical crises during this period.

Macro-economic and external factors such as currency fluctuations and interest rates¹⁵ are also put forward to explain such volatility. The growing correlation of commodity markets with each other and with other financial markets, resulting from the so-called “financialization” of these markets mentioned above, is also often pointed out.

These strong price increases have strong economic impacts for populations in developing countries, particularly for agricultural commodities which represent a large proportion of the expenditures of households, drawing the attention of the G20 to this matter.

Oil price fluctuations are considered to have had less economic impact than during previous oil shocks due to less ‘oil-intensive’ economies. The high levels of volatility observed in some markets and which seem difficult to predict are however considered to be detrimental to both exporting and importing countries and to players in the physical markets, since they make investments more risky and less predictable and could potentially lead to shortages. Steep price increases also impact participants holding futures positions, required by the exchanges to place larger amounts of collateral and margin and making commodities futures trading more capital intensive and expensive.

Some observers however point out that high prices, particularly in oil or energy, provided they reflect the balance between supply and demand may also lead to necessary investments in “cleaner” technologies and these technologies becoming viable.

2.2. Although the growing presence of financial investors in commodities markets is undisputed, identifying which way causation flows in the interaction between financial and physical markets is a complex issue¹⁶

The fact that strong volatility and price increases mentioned above took place at the same time as a growing presence of financial players in the commodities market and strong money inflows from index funds in particular, triggered suspicions that speculation in financial commodities may have strongly influenced the fluctuations of physical prices. According to figures published by the EU Commission in its February 2010 on commodities and raw materials “between 2003 and 2008 for example, institutional investors increased their investments in commodity markets from 13 Bio € in 2003 to between 170 and 205 Bio € in 2008. While the financial crisis interrupted the upward trend, financial positions approached or even exceeded their 2008 peaks on many markets in 2010 and investment by index traders in particular has increased strongly”.

The different studies conducted however show that there is no definitive consensus among economists on the impact of financial players on the evolution of commodity market prices. Indeed assessing the exact nature and extent of the link between the price formation process on commodities markets and the growing presence of derivatives markets is made difficult by the lack of transparency in these markets¹⁷ and further complicated by the fact that physical markets have different features. A major caveat in these studies is that data on commodity

¹⁵ For example a weakening US dollar and lower interest rates could raise demand and reduce production of commodities thereby exerting price pressures

¹⁶ Source MiFID review consultation document – EU Commission

¹⁷ Source: communication of the EU Commission February 2011

supply, demand and inventories, as well as OTC derivatives trading, is poor and lacks global coverage.

CFTC Commissioner Dunn for example stated on the 13th January 2011 that “to date, CFTC staff has been unable to find any reliable economic analysis to support...the contention that excessive speculation is affecting the markets we regulate”. The EU Commission in its February 2011 communication also wrote that “while it is clear that there is a strong correlation between positions on derivative markets and spot prices, it is still difficult to assess fully the interactions and the impact of movements in the derivatives markets on the volatility of the underlying physical markets”.

Many studies (for example those summarized by the OECD in 2010 or conducted by the IMF in 2008¹⁸) **argue that commodity prices are primarily or only driven by economic fundamentals which push prices up or down** (as mentioned above) and that trading in futures markets or capital inflows from index funds have little impact on the price run-up or the destabilization of underlying physical commodities markets. The main arguments put forward are that:

- No evidence was found of systematic causality in the statistical analyses conducted between commodity financial positions and prices in either direction. Analysts indeed found that the direction of financial flows was often inconsistent with the direction of price movements¹⁹.
- Volatility and price instability is structural in some markets, particularly when demand is inelastic (ie not price sensitive). For example in certain agricultural markets: when prices are high producers increase their production which leads prices to diminish the following year and which in turn leads producers to reduce production and prices to go up again. There are also seasonality effects eg temperatures impact on power prices.
- Since futures contracts only rarely involve the actual delivery of physical commodities²⁰, the impact on underlying physical markets is not obvious. However the fact that the contract is deliverable will inevitably create an interconnection with the physical market through anticipated convergence. In addition some point out that money inflows into financial products are not effective demand for the underlying commodities²¹. Market players are difficult to classify and separate with the data available, meaning that the influence of financial speculators is difficult to isolate: some large commodities dealers operate both in physical and derivatives commodities markets. swap dealers often hedge their positions.....
- Commodity markets with index funds and futures had similar evolutions²²
- There is no evidence of a generalized building of inventory of storable commodities during the period (and a decline in some cases), which is usually the case when financial players speculate in such markets²³. Some observers however point out that there may be some exceptions such as for example China in some cases.

¹⁸ IMF World economic report 2008 Chapter 3 – Commodity prices and inflation; OECD Working paper 2010 – The impact of index and swap funds on commodity futures markets

¹⁹ This approach consists in analyzing whether changes in commodity financial positions lead to commodity price changes using time-series analysis. For example while crude oil prices rose sharply in May and June 2008 net speculative positions declined – source IMF.

²⁰ only 1 to 5% of futures transactions end up with the physical delivery of the underlying asset

²¹ Other commentators add that index investors tend to exit contracts in advance of their going to physical settlement and that in instances where the contracts ultimately settle against the physical commodity this happens often at higher prices than those of the index investors, suggesting that supply and demand drive the price in that case.

²² eg fluid milk and rice futures which have no index fund participation or apples and edible beans which have no futures

²³ If a speculative bubble pushes spot prices beyond the fundamental price balancing supply and demand then the difference should be found in a build-up of inventory.

Some economists²⁴ however consider that volatility and price increases cannot always be explained by events in the physical markets and that financial positions can amplify price volatility – particularly in the short term - even if they are not their primary cause. This may be true for markets with a tight balance between supply and demand and / or inelastic supply or demand in which a relatively minor reduction in quantity of supplies or herding behaviours in a context of low inventories may result in very large increases in price at least in the short term.

- Money inflows in commodity index funds for example can influence the behavior of traders in commodity futures and underlying physical markets, fostering a sudden speculation in a given market which can possibly amplify short term price fluctuations. This can create a bubble effect with on-going anticipations of price increases which do not take into account the fundamentals of the underlying market. Prices should however be readjusted in the medium / long term.
- Financial investors (including individuals), particularly those investing through index funds allocating funds across various commodities, add a possible element of irrationality in the market with investors lacking familiarity with individual commodities and prone to herding mentality, which should be less the case with seasoned commodities investors. In addition financial investors increasingly tend to have an active approach to investing in commodity derivatives. This is usually the case for hedge funds. In addition, index management originally designed as a passive strategy to provide exposure to the market price, has taken on an active dimension in recent years with regular changes in the weightings of investments of different commodities according to expectations of the yields offered.

Most of these observers however conclude that due to the complexity of factors that drive prices and to limited data, continued monitoring of these evolutions and additional research are needed to improve the understanding on price formation mechanisms and the interactions between derivatives markets and the related commodity markets.

3. There is generally a consensus among regulators that the transparency of commodities markets needs to be improved as well as their supervision and coordination on a global level

Measures are being proposed both for the physical and financial commodities markets. Many commentators believe that a strong emphasis should be put on physical markets which remain largely unregulated in contrast with financial markets, at least exchange traded contracts, which are monitored by national supervisors.

3.1. Improving the global governance and transparency of physical commodities markets is a major challenge

A major caveat of all the studies mentioned above is that data on physical commodities markets and OTC financial markets is insufficient to draw definitive conclusions on the reasons for the strong volatility observed in these markets and on the interaction between financial and physical commodities markets. In addition data on the supply, demand and

²⁴ See for example the report prepared by Professor JP Chevelier on oil price volatility commissioned by the French Finance Ministry (Feb 2010), the report by Ch. De Boissieu and JP Jouyet on preventing and managing the instability of agricultural markets (2010) or some studies quoted in the OECD working paper on "The impact of index and swap funds on commodity futures markets" (2010).

inventories in physical markets is necessary in many cases to implement appropriate requirements for financial commodities markets and is critical to the satisfactory functioning of commodities markets and reliable price discoveries. Improved data is also necessary in order to detect possible manipulative trading by market participants holding large positions in commodity contracts.

A major priority put forward by most stakeholders is to improve the transparency of physical commodities markets which is a difficult challenge given the diversity and complexity of these markets. This was highlighted in particular by the IOSCO Task Force on Commodity Futures Markets reporting to the G20 on commodities issues.

This requires improving the governance of these markets for the data to be available and designing methodologies in order to ensure the reliability of the data collected.

Generally speaking the governance of commodity markets is fragmented among many independent bodies which do not always have complete geographical coverage, resulting in limitations in the data available and in the capacity to implement consistent rules. Some commodities are covered by no specific body at an international level.

International organizations such as the UN, the World Bank, the WTO, and their related bodies such as the FAO (Food and Agriculture Organization) and the IEA (International Energy Agency) for example play a role in the monitoring of these markets. OPEC (Organization of the Petroleum Exporting Countries) is also an important player representing major oil producing countries, as well as the US EIA (Energy Information Agency). In the agricultural sector, similar agencies exist but are fragmented: the International Grains Council covering grain trade is one of them.

Several initiatives have been launched to improve data on production and stocks in order to prevent possible crises: for example the JODI (Joint Oil Data Initiative) publishes monthly reports on the IEF website regarding oil markets²⁵. In addition to this the IEF (International Energy Forum) aims at developing consumer-producer dialogue and particularly understanding market fundamentals and the interactions between physical and financial markets and introducing regulation of oil financial markets.

In addition IOSCO has actively been engaged in working with the IEA, IEF, and OPEC to improve understanding of the processes and mechanics of the physical and derivative energy markets and to understand settlement pricing benchmarks created by energy price reporting agencies, as well as the corporate governance policies of these agencies.

Regarding non-energy and non-agricultural raw materials, the EU launched the EU “Raw Materials Initiative” in 2008 which is an integrated strategy to respond to the different challenges related to access such materials: identification of 14 critical raw materials at EU level, implementation of a EU trade strategy for raw materials, improvement in the knowledge base and increased resource efficiency and recycling.

Improving the transparency of the cash markets and their fundamentals will need to be examined sector by sector on an international basis. In some sectors, part of the answer lies

²⁵ JODI launched in 2001 aims at improving oil data and has put together a database covering more than 90 countries to collect data such as production, demand, refinery intakes and outputs and stocks. This database however has limitations since it is based on the data provided by the States and the industry which is sometimes considered as confidential for example regarding inventories. The EU does not provide complete data sufficiently regularly either according to some experts.

with greater regulation of physical market players (with respect to transparency of fundamentals in particular) and strengthening cooperation between financial regulators and the various types of organisation, including regulators in some sectors such as the electricity and natural gas markets²⁶ that play a major role in the physical markets.

3.2. Improving the transparency of OTC derivatives commodity markets is needed as well as improved reporting in on-exchange markets:

Requirements of the G20 to improve the transparency of OTC derivatives - with the implementation of one or several trade repository(ies) which should provide information on all OTC trades and mandatory clearing and trading, where appropriate, of sufficiently standardized contracts – will improve the data available on OTC commodity derivatives.

Additional measures have been proposed by IOSCO to improve the transparency of on-exchange commodity markets:

- Recommendations are being made in the US to extend the present large trader reporting system (Commitment of Traders Report of the CFTC)²⁷ for relevant on-exchange contracts to improve this reporting for large swap positions in 46 commodities, expanding the number of trading firms concerned and increasing the frequency to daily. The proposed reporting system should serve as a transitional tool for swaps positional data until swap data repositories are in operation.
- The EU Commission has recently proposed in its consultation document for the review of the MiFID Directive to introduce a position reporting obligation by category of traders for contracts traded on all EU organized trading venues which admit commodity derivatives to trading (i.e. regulated markets, MTFs or organized trading facilities).
- Whether publishers of information on physical transactions (eg price reporting agencies such as Platts, Argus) need to be regulated in any way should also be examined to ensure that the reported data accurately reflects the cash markets covered.

3.3. Research is required to better understand transaction flows and the process of price formation:

In addition to increasing the availability and accuracy of data available on commodity markets, many regulators consider that research should be conducted, for example for energy markets on:

- The transaction flow of the physical and derivative markets: in order to understand the detail, quantity, value and proportion of transactions in the OTC and listed derivatives markets and to define the appropriate approach for data collection
- The process of price formation and the sources of prices volatility: value and accuracy of prices generated by price reporting agencies, value of existing price benchmarks, stability of spread differentials used in conjunction with price benchmarks, convergence issues between the physical and derivatives markets, impact of listed derivatives pricing on OTC contracts and vice-versa, sources of price volatility

²⁶ See the recent proposal by DG Energy of the European Commission for a regulation on the transparency and integrity of the energy markets,

²⁷ Under this system, brokers, exchange clearing members and foreign brokers file daily reports with the CFTC that show futures and options, positions of traders at or above specific reporting levels set by the CFTC. The aggregate of all large trader positions reported to the CFTC usually represents 70 to 90% of the total open interest of a given market.

This should help to develop the appropriate regulatory actions for enhancing market transparency and efficiency.

3.4. The scope of supervision should be extended and the coordination between physical and financial supervisors improved

Physical commodities markets are beyond the jurisdiction of most regulators: the US CFTC and the UK FSA for example, that are the regulators of the most important commodities markets mainly focus on derivatives rather than physical markets. This situation probably needs to evolve to ensure an appropriate supervision of physical commodities markets. In the same way IOSCO has little authority over physical markets.

Proposals are being made in the US and EU to improve the supervision of commodity derivative markets and investment firms active in commodity markets.

Improvements would involve market authorities having access to data used to identify concentrations of positions and the overall composition of the market, exchanging relevant data with each other and if appropriate with the authorities responsible for underlying markets and upgrading market monitoring programmes. This requires developing the necessary expertise and tools within regulators, particularly for the OTC markets for which it will not be possible to rely on the self-regulatory role of exchanges.

In the US the Dodd Frank Act gives the CFTC oversight of the OTC derivatives including OTC commodity derivatives which involves that contracts will have to be reported and that standardized ones will have to be cleared and where appropriate traded on an organised market.

In the EU progress is being made in some sectors. For example the Agency for the Cooperation of Energy Regulators (ACER) will look at energy markets in cooperation with equivalent financial authorities, primarily the European Securities Markets Authority (ESMA). With the development of the EU Regulation for Energy Market Integrity and Transparency, the cooperation between physical and financial supervisors in the energy sector will come within the regulated space, both cross-border and within countries.

4 Additional measures are currently being discussed for financial commodities markets to curb speculation and avoid manipulations

4.1. Market abuse rules may need to be adapted for commodities markets:

Market abuse rules aim inter alia at avoiding manipulations related to large dealers holding disproportionate positions in the market or holding information which could potentially impact the market. Such rules are defined in the EU Market Abuse Directive (MAD) but require sufficient data and visibility on the market to be effectively implemented²⁸. In the US the CFTC has broad authority to prosecute manipulative behavior on commodity derivatives to the extent there is an impact on futures and the authority to adopt rules under Dodd-Frank in respect of swaps. Exchanges also play a role in market surveillance.

²⁸ The EU Commission is planning to clarify at the occasion of the review of MAD in 2011 what trading in commodity markets constitutes abuse and to ensure that all venues and transactions where abusive practices can occur are properly covered under pan-EU rules

Specific measures to avoid cross-manipulations between financial and physical markets could also be proposed e.g. possible position limit proposals (see below) to avoid market “corners” or “squeezes” with for example large long or short positions, relatively to the size of the market, being built in the physical or derivatives market, with the objective of influencing prices artificially. This of course requires having a sufficiently complete view of the market.

4.2. Specific solutions proposed for regulating commodities derivatives are currently being discussed in the US and the EU for which appropriate coordination is required on a global level:

Solutions are being examined both in the US and the EU to mitigate the specific risks posed by commodity derivative markets: particularly regulating market players, setting position limits and developing position management processes.

The EU Commission is also considering options to reinforce the powers of supervisors beyond these proposals, which could include the possibility for the Commission and for national regulators to temporarily ban or restrict the trading or the distribution of a product by one or more investment firms or the provision of an activity “in case of exceptional adverse developments which constitute a serious threat to financial stability or to market confidence in a Member State or the EU”. This would apply primarily to complex products such as certain types of structured products.

Strong coordination is required at G20 level to ensure sufficient consistency of rules on a global level.

Regulation of market players:

- Proposals have been made by the CFTC to define swap dealers and major swap participants in OTC markets in addition to the existing classification of participants for on-exchange markets²⁹ and to review the capital and margin requirements for swap dealers and major swap participants.
- MiFID currently defines requirements for investment firms. The December 2010 consultation paper for the review of the Directive mentions exemptions for commodity firms when dealing on own account in financial instruments or providing investment services on an ancillary basis and the intention to address in a separate review the capital requirements applicable to other investment firms. Some EU regulators are of the opinion that all significant dealers and brokers in the commodity derivative markets should be licensed and regulated. They add that in Europe, the scope of the current MiFID exemptions should be narrowed, notably taking into account the new US regulatory perimeter under the Dodd Frank Act so as to achieve the broadest possible convergence. This would involve licensed dealers and brokers in the commodity derivatives markets being subject to appropriate capital and liquidity standards, organisational requirements and conduct of business rules (conflicts of interest, disclosure, suitability...).
- This will help to monitor commodities markets and to implement trader reporting for on-exchange markets as well as for OTC trades.

²⁹ Market players can be divided up into 3 categories (using the categories defined by the CFTC): commercial players who are involved in the physical commodities (producers, manufacturers, merchants), traditional non-commercial players (financial players ie brokers, traders and hedge funds who trade commodities and do not use future contracts to hedge) and swap dealers who trade swaps and options.

Position limits and position management:

- Position limits aim at prohibiting the concentration of large positions in the accounts of one or few traders in order to limit market manipulation risks and avoid excessive speculative positions.
- The CFTC currently sets position limits in certain agricultural markets (ie corn, oats, soybeans, wheat, cotton). The new Dodd-Frank financial reforms require the CFTC to set position limits for commodity futures and swaps³⁰.
 - o Limits have first been proposed by the CFTC for four energy commodities, and should apply to all CFTC regulated exchanges³¹. The proposed limits are responsive to the size of the market and are set by a formula based on a % of total open interest (i.e. of existing contracts).
 - o Caps are also proposed to limit the number of contracts that investors can hold in 28 raw materials including oil, gold, copper and corn with limits set for spot commodity contracts at 25% of deliverable supply³².
- In the EU, the EU Commissioner for internal markets backed the objective of limiting traders' positions and announced that changes would be introduced via the MiFID Directive under review. The consultation paper published in December 2010 mentions that the Commission is considering giving regulators "complete powers to manage and control positions in commodities derivatives more rigorously" in order to prevent market manipulation and manage settlement risk. Setting ex ante position limits both for derivative contracts traded on-exchange and OTC could be part of a "heightened level of position management" for addressing risks to the overall stability of physical commodities markets. If adopted these proposed measures could form a separate chapter of the revised MiFID framework.
- The proposal to establish position limits is contentious in the US. The first concern put forward within the CFTC was their feasibility with the difficulty to obtain at present reliable data on the size of swaps markets and players' positions in privately-traded OTC contracts³³. In the absence of a clear position on this issue, the vote of the CFTC on these measures has been delayed, an option considered being to apply hard position limit rules only once the data on swap markets is available. The economic validity of position limits is now being more openly questioned as well, for example by CFTC Commissioner Dunn who recently stated that "to date CFTC staff had been unable to find any reliable economic analysis to support that position limits will prevent excessive speculation. With such a lack of concrete economic evidence, my fear is that, at best, position limits are a cure for a disease that does not exist or at worst, a placebo for one that does". He added that "there has been the suggestion by some that once we set position limits on physical commodity derivatives, the price that we pay for gas, bread,

³⁰ Energy and metal limits face a mid-January 2011 deadline and agricultural market limits must be finalized in April.

Proposed rulemaking maintains exemptions for entities using the futures markets to hedge commercial risks known as bona fide hedging exceptions.

³¹ Currently positions in these energy contracts are not subject to CFTC or exchange-set limits, except for positions in spot month contracts which are subject to exchange-set limits. Limits should apply to aggregate positions in futures and options combined (both physically settled and cash settled) plus some individual contracts.

³² These rules should affect around 70 traders in agricultural commodities, 40 in energy contracts and 14 in base and precious metals.

³³ As mentioned previously the primary source to complete existing trader reporting for OTC trades should be swap data repositories but those are not operational yet

milk and other things would inevitably drop, and that volatility in commodities markets would simply cease to exist. I believe this is a fallacy”

- Within the industry, many players have called for a cautious or more focused approach to position limits. The main arguments put forward are that:
 - o Position limits can result in reduced market liquidity and consequently impairing price discovery, which in turn can contribute to greater volatility, in part due to reduced hedging opportunities and to potential cost increases for end-users.
 - o There is no consensus at this stage, as mentioned previously that price increases and volatility are caused by the increased presence of financial investors and that capping their positions could have a positive effect on these evolutions. Furthermore there is no concrete evidence that such tools are effective in monitoring, detecting and deterring possible manipulative behaviour.
 - o The approach to such rules should be coordinated on a global level to avoid regulatory arbitrage (leading trading to move overseas) and modalities to apply such rules to the OTC commodities market (in order to avoid trades to potentially move from regulated exchanges to less regulated OTC markets).
- Proposals have been made to better focus possible position limits: directing them at spot month where susceptibility to market imbalances is the greatest, recognising offsets of positions in different contract types (ie futures vs swaps) based on the same or similar underlying commodities... An alternative could be for regulators to resort to position limits on a temporary basis e.g. when markets are exposed to specific threats or instability.
- Position management processes are an alternative option worthwhile considering for many stakeholders.
 - o The EU Commission in the consultation document for the review of MiFID published in December 2010 proposes to implement “position management” processes, bestowing regulators with powers to ask market players to provide explanations for positions and / or request players to reduce the size of a given position. Such a system has also recently been proposed by the UK FSA.
 - o Leaders of the industry have also proposed coordinating more effectively the position management processes currently utilized by certain exchanges in order to deal with market manipulation risks³⁴ for exchange traded derivatives.

³⁴ They advocate that such measures can be tailored to the contracts concerned and have been shown to be effective in preventing market abuse, particularly squeezes. Commodity exchanges can also enforce the reduction of positions through membership rules