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Regulation of commodity derivative markets – Critical assessment of reforms in the EU

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Commodity prices that are increasingly determined on global commodity derivative markets are important for economic and social development. The historically unprecedented commodity price boom – combined with high volatility – since the early-2000s has led to a debate about the functioning of commodity derivative markets. In the context of an international political consensus on the necessity to reduce excessive speculation, the EU has introduced several reforms. They include important measures on improving transparency, limiting market power and strengthening regulatory authorities but their effectiveness will strongly depend on the implementation rules that are currently discussed. More interventionist regulations that address the fundamental problems of these markets and limit the dominance of financial investors were only marginally addressed.

Commodity prices have crucial implications, in particular for developing countries that are often dependent on the import and export of commodities. An understanding of commodity prices and their determinants are therefore important for economic and social development. Commodity derivative markets, where contracts are traded that provide the obligation or right to buy or sell a commodity at a specific price in the future, have an important role for commodity prices by providing two functions. First, the *price discovery function* as trading on futures markets[1] enables the open-market discovery of commodity prices that are used as a benchmark for physical transactions and as a basis for decisions on production, consumption and investments. Second, commodity derivative markets offer an *insurance function* as they enable spot market participants to hedge against the risk of price fluctuations. With the dismantling of price stabilization systems in the last decades, this function has become important for producers, consumers and traders of physical commodities.

The rise of commodity prices in the 2000s has coincided with deregulation of commodity derivative markets and a dramatic increase in the size of and in the share of traders from outside physical commodity markets, especially financial investors, on these markets. The increasing dominance of these non-commercial traders has changed the microstructure of commodity derivative markets – in terms of trading volumes and open interest positions, investment products and strategies, speed and complexity. The impact of financial investors' trading strategies – that are often not based on fundamental demand and supply conditions but on macro models, technical/algorithmic trading or high frequency trading (HFT) – on prices has been controversially debated but there seems to emerge some agreement that the so-called "financialisation of commodity markets" has increased the likelihood of excessive short term price fluctuations. These developments *question the price discovery function* of those markets and make them less reliable for decisions and planning of commercial traders. Always a difficult risk management instrument particularly for smaller commercial traders with limited capacities to monitor financial markets and access to finance, *hedging has become even more complex*, expensive and inaccessible (see Heumesser/Staritz 2013 for more details).

In this context, a political consensus emerged within the Group of 20 (G20) and other countries on the necessity of *reforms to reduce excessive speculation.* In order to fulfill the G20 commitments and following US legislation, the EU has – within a broader financial markets regulation agenda post 2008/09 – introduced several reforms for commodity derivative markets. This policy note gives an overview of the current reforms in the EU and assesses their scope and limitations (see Staritz/Küblböck 2013 for more details). In the assessment, the primary functions of commodity derivative markets for the real economy and hence for commercial traders are taken as the point of reference.

EU legislation on commodity derivatives

EU legislation on financial markets, including commodity derivates, is characterized by a highly fragmented set of directives and regulations. Up to the financial crisis in 2008, EU legislation mainly focused on deregulatory measures with the objective to create a single European financial market. Especially the Markets in Financial Instruments Directive (MIFID) that came into force in 2007 was a key element of EU financial market legislation focusing largely on deregulation. It liberalized financial markets, allowing trading venues and investment firms to operate freely across the EU, creating so called multilateral trading facilities (MTFs)[2], and enhancing competition between organized exchanges and MTFs. The dynamics changed however in the aftermath of the financial crisis. Since 2009 existing legislative instruments have been revised and new regulations have been introduced with the aim to strengthen oversight and regulation, influenced by the G20 commitments and modeled on the US Dodd-Frank Financial Reform Act. The two most important legislative acts for the regulation of derivative contracts at the EU level are the European Market Infrastructure Reg-

ulation (*EMIR*), adopted in August 2012, and the Markets for Financial Instruments Directive/Regulation (*MIFID II/ MIFIR*) that entered into force in July 2014, and will be applicable starting January 2017 (EC 2014). The negotiations of those pieces of legislation have been accompanied by intense lobbying efforts, particularly by the financial industry but also by civil society organizations.

EMIR is the main legislative instrument to reform "*Over The Counter*" (OTC) derivative markets. OTC means that contracts are traded directly between market participants, without using organized trading facilities such as exchanges. Up to the financial crisis, OTC trade was largely unregulated and contracts were not reported to supervisory authorities. The intransparency of those markets, the potential risk of high volumes of OTC trading and the interconnectedness of market participants aggravated the financial crisis in 2008/09. EMIR hence aims at enhancing transparency of OTC-trading and mitigating the risk of contagion. The main measures that are introduced to achieve those goals include:

(i) *All* derivative transactions must be *reported* to a trade repository which is supervised by the European supervising authority ESMA in order to enhance transparency.

(ii) *Standardized* OTC derivative contracts must be *cleared* via a central counterparty (CCP)[3]. Clearing means that the two parties replace their bilateral contract with two separate contracts that each holds with a CCP. This should prevent that the bankruptcy of one party causes insolvency problems for the other party and subsequently other market participants. However, derivatives contracts entered by a non-financial party related to commercial or treasury financing activity are not affected by this regulation.

(iii) *Non-standardized* and therefore non cleared OTC derivatives will be subject to *certain obligations* (e.g. higher capital requirements) in order to reduce risks and, hence, are likely to become more expensive.

The second piece of legislation, *MIFID II/MIFIR* applies to all financial instruments that are *traded on exchanges and other platforms* and therefore do not fall under EMIR. Those instruments include, for example, shares, bonds, structured products and exchange traded derivatives, including commodity derivatives that are traded on exchanges/futures markets. The main reforms introduced by MIFID II/MIFIR include:

(i) Introduction of ***position limits***, i.e. a maximum size of a position in a commodity derivative that a trader can hold. They are meant to reduce the likelihood that a single trader can obtain positions large enough to manipulate or dominate the market. The position limits introduced by MIFID II/MIFIR apply to commodity derivatives on trading venues as well as to "economically equivalent[4]" OTC commodity derivatives. Limits will apply to the "net position", meaning that a trader can calculate two opposite positions as a zero position. They will be defined by national authorities based on a calculation methodology from ESMA. Whether position limits will be effective will therefore depend on how the limits are calibrated (Finance Watch 2014). In any case, they do not apply to classes of traders and to positions held by a non-financial entity for reducing risks directly related to the commercial activity of that entity and also not to positions held on behalf of a non-financial firm which represents a potential loophole (Henn 2014).

(ii) An obligation to shift certain ***standardized OTC*** derivative contracts to ***more regulated trading places*** to increase transparency. ESMA still has to define a list of derivatives that are subject to this obligation.

(iii) Creation of ***new trading platforms***, so-called organized trading facilities (***OTFs***), which are allowed to set discretionary rules for bringing together buying and selling interests of market participants. The aim is to shift OTC trading to more regulated platforms. A danger is however that trading on exchanges that is most regulated and transparent will shift to OTFs which may reduce overall transparency.

(iv) ***Real-time reporting*** of all derivatives that are eligible for clearing (or otherwise required to be reported) to trade repositories, that have to publish weekly reports on positions of classes of traders.

(v) Investment firms that engage in ***HFT or technical/ algorithmic trading*** must have in place effective systems and risk controls, notify the authorities on their activities and keep records. Trading venues will only be allowed to quote prices in certain intervals (tick sizes), and will need to have a "circuit breaker" – i.e. they can stop the trading in case there is a problem with prices such as very quick surges or falls (Henn 2014).

(vi) ***Supervision*** will be strengthened by harmonizing sanctions and by giving European and national supervisors the ability to intervene and ban certain products if they are dangerous. This can even happen on a "precautionary basis", so before the product is sold (Henn 2014).

Scope and limitations of current EU reforms

Importance of implementation rules: The effectiveness of these rules will largely depend on their exact definition in the technical implementation stage guided by ESMA and the European Commission (EC) (so-called "Level Two"). MiFID II/ MiFIR contains almost 100 requirements for ESMA to draft Regulatory Technical Standards (RTS) and Implementing Technical Standards (ITS), and to provide Technical Advice to the EC. Key points concerning exemptions and details on certain regulations will be only settled in these rules. In May 2014, ESMA launched the consultation process for the implementation rules and is expected to publish its recommendations to the EC, Parliament and Council in mid-2015 and technical standards in late 2015 or early 2016. Concerted lobbying efforts of the financial industry will focus on those "Level Two" standards, while the public mobilization and impact that civil society organizations were able to reach during the first phase of legislation will be more difficult to maintain during this more technical – but decisive – phase.

Reporting of OTC-trade: The mandatory reporting of OTC derivatives will enhance transparency for supervisory authorities. However, it should be mandatory for all trading to take place on regulated, transparent and public exchanges. In cases where OTC trading might still be necessary as commercial traders may require specific non-standardized contracts to hedge price risks of their physical commodity activities, there should be only limited exceptions with strict requirements. Regulators would need to work with commercial traders and financial actors to standardize OTC derivatives. The responsibility should then lie with commercial traders to prove to regulators that any remaining OTC contracts exist for the hedging of genuine commercial risk and cannot be achieved through standardized exchange traded contracts (WDM 2011).

Position limits: It is the first time that the EU limits the maximum size of a position that traders can hold which is an important step to prevent market abuse and manipulation and was a key demand from many civil society groups. However, position limits are only applicable to individual traders and not to classes of traders (aggregate position limits) which would be important to reduce the influence of certain types of traders, i.e. index investors or technical/algorithmic traders, and avoid circumvention by splitting into different entities. It would for example still be possible that 40 investment banks, hedge funds or other financial units hold 100% of positions in a market. Further, position limits should be established at the EU level and not nationally as this might lead to competition among member states and therefore inadequate limits and oversight. Position limits also need to explicitly cover all trading platforms, including regulated markets, MTFs, OTFs and all OTC trade[5]. There should also be no general exemptions for any types of traders and for treasury financing activities. Hence, when a commercial trader takes positions that are larger than its underlying physical commodity business it must be subject to position limits for the positions taken above hedging requirements. Financial investors should not be allowed any position limit exemption, making it impossible to avoid position limits by taking control of physical commodities. Moreover, position limits need to apply to net and gross positions and to all types of contracts in order to avoid circumvention (Vander Stichele 2012).

Clearing and trading platforms: Whether the clearing obligation will reduce the risk of contagion or whether the CCPs represent a new source of systemic risk remains a topic of discussion. The same applies to the creation of OTFs as new platforms – whether more OTC-traded derivatives will be shifted to those platforms or whether instruments formerly traded at more regulated markets will shift to OTFs still remains to be seen (Henn 2014; Giegold 2013). The outcome will also depend on the standards determined by ESMA. Which derivatives will be subject to the trading obligation, how the hedging exemptions will exactly look like or even the definition of the term "OTC" itself will also depend on ESMA standards.

Broader regulations missing

Putting the still missing implementation standards to one side and taking a closer look at the areas of reform, it has to be noted that most attention has been given to transparency and risk management, in particular concerning the previously largely unregulated OTC markets, and to a certain extent also to limit market power via position limits as well as to strengthen regulatory authorities. *More interventionist regulations* that address the actual role of commodity derivative markets and limit the dominance of financial investors have *only marginally* been addressed. These would include measures to stabilize commodity prices, the restriction of certain kinds of investment vehicles and strategies and taking into account the multiple and interrelated roles of large commercial traders and financial investors.

One particular problem that remains unaddressed by current regulation is the increasingly difficult distinction between *hedging and speculative actitivies*. Some large physical commodity traders have separate financial investment units or own hedge funds, and investment banks or hedge funds are increasingly engaged in physical commodity production, warehousing and trading (Vander Stichele 2012). Given the multiple and blurring roles of large commercial and financial traders, rules that differ between those two types of traders (such as the hedging exemption for commercial traders) do not capture the actual complexity of trading. Non-financial entities should therefore not be exempted from clearing and margin rules requirements as this might create important loopholes. Data collection about different types of traders and their strategies has to be improved. Traders should have to disclose the type of their entity[6], their trading strategies and the purpose of their transactions.[7]

The increasing *volatility of commodity prices* also represents a particular challenge – for commodity exporting or importing countries, producers and traders. Regulation should therefore aim at stabilizing commodity prices. There were no explicit discussions within the EU to develop instruments to address excessive commodity price volatility to signal to traders that destabilising speculation will be counteracted. One proposal in this regard is a multi-tier financial transaction tax (FTT) with a small permanent tax rate and a significantly higher second-tier tax rate in case the price leaves a pre-defined dynamic price band. Such a tax-based price control system would allow price adjustments but large short-term fluctuations would be prevented. The small tax rate would in particular affect and reduce very short-term trading as it accrues for each transaction[8]. Further reforms beyond derivative markets will be also necessary to stabilize commodity prices and reduce vulnerability. This includes measures such as price stabilization schemes and strategic stocks at the national (or regional) level, and the introduction of international counter-cyclical financing facilities (Nissanke/Kuleshov 2012).

One issue that also remains largely unaddressed are the *negative effects of certain trading strategies and instruments* that may lead to overshooting of price movements and high short term volatility unrelated to fundamental supply and demand factors. In particular, the practice of commodity index replication and exchange traded products (ETPs) are controversially discussed for pushing prices up and changing the term structure of commodity prices. In addition HFT where transactions are pursued in milliseconds and technical/

algorithmic trading more general have been criticized for accelerating price swings, particularly in the short term (Schulmeister 2012). Such trading strategies could be restricted for example by setting tighter position limits for individual traders and trader classes or demanding higher security requirements (i.e. capital and margin requirements). HFT and other short term trading strategies would also be affected strongly by a FTT as discussed above. However, in the current legislative text there are no explicit proposals to restrict certain trading strategies and actors.[9] The minimum holding time for offers (to limit HFT) that had been part in former drafts of MIFID was not included in the final legislative text.

The proposed strengthening of supervisory authorities is a positive step, however it would be necessary to link supervision to a *global regulatory authority* (that is stronger than existing bodies as FSB or IOSCO) to oversee commodity derivative markets and trading. This is important as derivative trading takes place at a global level and often involves the jurisdiction of regulatory authorities in different countries.

Conclusion

Important regulatory initiatives have been taken at the EU level in respect to improving transparency and reporting (especially concerning OTC trade), installing position limits and strengthening regulatory authorities. However, these regulations have limitations, in particular in the form of important exemptions. Moreover, if those regulations will be effective will to a large extent depend on the "Level Two" regulation defined by ESMA in 2015/16. Therefore, this rulemaking will be accompanied by intense lobbying efforts by the financial industry. For civil society organizations, it will be important to build pressure during these "Level Two" negotiations to ensure that the potentially positive regulations are not watered down through implementation rules. However, in key areas that would address the fundamental problems of commodity derivative markets and limit the dominance of financial investors, regulations were only marginally addressed, such as price stabilization instruments, restrictions on certain trading strategies, products or actors, and the multiple and interrelated role of financial and commercial traders.

1 Derivatives can be traded on organized exchanges (i.e. futures markets) or bilaterally Over the Counter (OTC).

2 A MTF is a multilateral system operated e.g. by an investment firm, which brings together third-party buying and selling interests in financial instruments. Liberalization led to a multiplication in trading venues.

3 This only applies if they exceed the clearing threshold of Euro 3 billion. According to ISDA around 70-80% of OTC derivatives are clearable (ISDA 2013).

4 This still needs to be defined by ESMA.

5 Currently the formulation is economically adequate OTC-trade which leaves room for interpretation for ESMA.

6 Such as physical commodity trading house, investment bank, hedge fund, etc.

7 This obligation exists for some traders such as commodity trading advisors (CTAs) but not generally for participants on commodity derivative markets.

8 The introduction of a FTT is currently discussed in 11 EU member states in the procedure of "enhanced cooperation", which would also apply to derivatives but it is still contested and not clear (as of November 2014) which kind of derivatives will be included.

9 The text includes the option of supervisory authorities to intervene and ban certain products. If they exert this power remains to be seen.

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