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ISDA's Comments on the Commission Communication on Challenges in Commodity Markets and on Raw Materials

On behalf of its members, the International Swaps and Derivatives Association (ISDA) would like to take this opportunity to comment on the issues raised in the European Commission's recent Communication on 'Tackling the Challenges in Commodity Markets and on Raw Materials'.[1] This paper seeks to contribute to the debate on commodity markets by focusing on the value of greater transparency and the need for regulatory powers that support the orderly functioning of markets – including position management powers. The paper also illustrates why maintaining a diversity of execution venues matters in this context.

ISDA recognizes the importance of examining issues of volatility and high prices in food and energy markets, given the associated impact on consumers and producers in both developed and developing countries; we hope that the observations contained in this paper will help the Commission in the task of "improving the regulation, functioning, and transparency of financial and commodity markets", whilst at the same time preserving the ability of those markets to serve the real economy by allowing commercial participants to hedge risk effectively. Policy proposals will of course need to be based on sound academic research and market data, otherwise there is a risk that new rules could in fact cause volatility to increase.

ISDA also believes that the Commission is right to highlight the various legislative and industry-led initiatives that are already underway and that will go a long way to making these markets more transparent for the public and regulators alike: we welcome the central clearing of commodity derivatives where this reduces systemic risk and believe that the creation of a trade repository for commodity derivatives, something for which ISDA is taking a lead, will contribute greatly to ensuring the existence of appropriate data for supervisory oversight. Proposals to revise the scope of the Market Abuse Directive (MAD) and introduce further transparency in physical markets through the Regulation on Energy Market Integrity and Transparency (REMIT) are also welcome. For these initiatives to be successful, they will need to be consistent and complementary, something particularly relevant when it comes to transparency measures.

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[1] COM(2011) 25 final

We also believe that regulators should continue to enforce current rules if abuse does occur, although we would emphasise that the evidence suggests that abuse is isolated rather than widespread.

ISDA would, of course, be happy to discuss any of the points raised in this document.

1. Market trends

We welcome the Commission's recognition that shifts in supply and demand are at the heart of the developments that we have witnessed in commodity markets. Over the past 10 years, there has been a huge increase in demand from developing economies for food and energy, most prominently in China, India and Brazil. Rapid economic growth, accompanied by industrialization and urbanization, has seen a continued increase in demand for oil and other raw materials, while the resultant rise in living standards has seen a greater demand for food, as well as changes in dietary patterns. Demand is further enhanced by subsidization of the costs of some commodities by both developed and developing countries.

The Commission is also right to note that financial investment flows into commodity derivatives markets have increased over the same period. However, whilst it acknowledges the existence of "multiple factors influencing commodities prices", we believe that the Communication does not go far enough in emphasising that an increase in derivatives trading alone cannot drive up or drive down commodities prices in the long term. For every trader or investor who buys a commodity forward, for example, there must also be a seller. Most of these contracts are cash settled (particularly in the case of OTC derivatives), so derivatives trading need not have an impact on the underlying cash market. Put simply, there is no evidence to suggest that trading in commodity derivatives – speculative or otherwise – has caused volatility or price rises in the underlying markets.

We would also suggest that the Commission's assertion that "price movements across different commodity markets have become more closely related, and that commodities markets have become more closely linked to financial markets" oversimplifies the relationships between different commodity markets and between physical and financial markets.

2. The role of commodity derivatives markets

As for the role of commodity derivatives markets, we believe that the societal value that derives from these markets is all too often overlooked in discussion of how they can or should be improved. That value reflected in the diversity of participants in commodity derivatives markets in comparison to derivatives in other assets classes.

Take the example of an agricultural producer, who can agree a futures contract with a financial institution willing to take a view on the weather and harvest yield. The producer will thereby lock-in a guaranteed price for his product, regardless of the supply and demand conditions following the harvest. As the producer agreed this transaction in advance, he therefore has no incentive to hoard the crop as protection against futures shortages. Producers in commodities markets – such as miners, oil producers and farmers – depend on the existence of commodity derivatives markets in order to manage the risks to which they are exposed.

This ability to manage risk also has an important development angle. For example, in order to maintain the pace of its infrastructure improvements, the Mexican government decided in both 2008 and 2009 to protect against falling crude oil prices by purchasing over-the-counter put options giving Mexico the right but not the obligation to sell crude oil at an agreed 'strike' price at regular intervals during the year. In this way, developing countries are able to protect the revenues essential to their continuing development.

Here it is also worth emphasising the important role played by non-commercial participants in these markets: by virtue of their willingness to take on the commercial risks confronted by producers in their core commercial activities, or by national governments in their trade activities, these entities, whether they be intermediaries, passive investors or speculators, perform a function that is vital to the health and wealth of the real economy. Any measure aimed at restricting or removing them from the market would likely harm liquidity and therefore increase volatility.

3. Policy challenges

We welcome the Commission's commitment to enhance the oversight and functioning of commodity markets and believe that well-designed, evidence-based regulatory intervention will enhance these markets to the benefit of the wider economy. Below we comment in more detail on a number of the issues currently being discussed. It is also worth remembering the diversity of participants in these markets to ensure that rules are tailored accordingly.

Transparency

The Communication notes that it is "clear that the degree of transparency and reporting obligations on both the underlying physical markets and the derivative markets should be enhanced". On this point, it is worth highlighting the wealth of public transparency that already exists in commodity derivatives markets: pre-trade information is consolidated via exchanges, electronic trading platforms and major dealer pricing information, and most commodity exchanges and MTFs already publish post-trade information on a transactional basis.

That said, we welcome the Commission's Consultation on the MiFID Review, in which it proposes measures to enhance transparency in these markets. As noted in our response to the Consultation, we support the development of a formal post-trade transparency regime with time delays and size-related thresholds, as long as it is sensitive to the varied nature of different commodities markets. Introducing a pre-trade transparency regime, on the other hand, could be detrimental to the end users of commodity derivative markets, in that it could lessen liquidity and thus encourage the sort of volatility that regulators wish to moderate, whilst increasing the costs of hedging.

As for additional information for regulators, industry has made good progress in its work on a central trade reporting repository for Financial Commodity OTC Derivatives. This will be designed to record all trade types, whilst also providing a structure to report the information to regulators. The industry aim to record all oil derivatives trades in a centralised reporting repository by a target date of no later than 1 January 2012.

Ultimately, the success of regulation designed to promote transparency requires clarity as to the intended purpose of the data – whether to foster market efficiency or to provide regulators with data to monitor for market abuse or systemic risk build-up – with that purpose being reflected in the detail of proposed rules. As part of this, it will be important to ensure that the transparency requirements associated with different pieces of legislation, such as MiFID and EMIR, are consistent. It is also important to understand that further transparency in derivatives markets will only provide meaningful information if there is an equivalent level of transparency in physical markets.

Position management

The Communication also refers to position limits as a possible regulatory tool that could be considered, presumably to prevent market manipulation and control prices to some extent. As far as avoiding market manipulation is concerned, we believe that the inflexible nature of position limits means that they are not as useful a tool as position management powers, something that we explore below. We are not aware of any evidence to suggest that position limits are effective at controlling or limiting price movements or volatility; furthermore, high prices cannot be seen as evidence of market manipulation and more typically relate to fundamental factors.

Above all, our concerns about position limits relate to the risk that they could distort the functioning of markets. Proponents of position limits highlight the fact that they are transparent and give the market certainty as to the regulatory treatment of large positions. There are two problems with such an assertion. Firstly, determining position limits and the scope of associated exemptions itself involves a high degree of regulatory discretion and thus will always in some senses be arbitrary. Secondly, while it may be clear to the market when a position limit is reached, limits are likely to harm transparency overall, as the illiquidity that could be caused by position limits may actually mislead market participants by obscuring the underlying factors behind price movements in commodities markets. Whilst the Communication highlights the problem of delayed price transmission between world markets and national markets, it is worth considering that position limits could in fact exacerbate such delays by distorting the price-formation process in a given market.

Thus we believe that regulators should instead have appropriate position management powers in order to ensure the orderly functioning of commodity derivatives markets:

- For exchange-traded instruments, the Competent Authority is likely to task the relevant market operator with position management; as such, the Competent Authority would also be empowered to ensure that market operators build position reporting requirements into the rules of the exchanges they operate, so that the regime can be enforced.
- The exchange operator would be given the authority to manage positions at any time throughout a contract's life cycle and to instruct a market participant to close or reduce a position, if that is necessary to secure fair and orderly markets. By way of example, the rules of the London Metal Exchange oblige holders of dominant positions to lend metal at fixed rates.
- The Competent Authority would also be able to empower exchanges to close positions unilaterally if members did not comply with position management instructions.
- To the extent that relevant instruments are traded off-exchange, the data collected by trade repositories or central counterparties could be used to provide Competent Authorities with a clear view of large positions.
- Competent Authorities should have the power to request further information from a market participant on a position, and whether it is settled in cash or physically.

Unlike hard position limits, such an approach would allow regulators greater scope to make decisions that are reflective of factors such as the level of liquidity at a given time and the nature of participants in a market.

Venue selection

The final point on which we would like to comment is the matter of venue selection. The Communication refers to the MiFID review and the Commission's intention to set "conditions for when commodity derivative products should trade exclusively on organised trading venues."

We believe that while increased use of organized trading platforms may bring benefits in some markets, the mandatory or incentivized use of organized platforms – whether in general terms or in terms of promoting a particular model of organized platform – will not reduce risk and will negatively affect market participants and markets in general.

It is important to appreciate that cash, future, and OTC derivatives markets are complementary – they interact with each other and provide investors with a diverse choice based on their risk management or investment needs. The existence of an organized market for a given product does not necessarily imply greater efficiency relative to an over-the-counter market in tailored products or insulate a market from criticism based on the degree of perceived speculation: for example, with reference to the Commission's discussion of agricultural derivatives (p.4), it is worth noting that this market is already largely exchange based.

As we emphasized in our response to the MiFID Consultation, we therefore believe that any changes to the MiFID regime should support, rather than detract from, the existing diversity of execution models. This suggests that the proposed OTF regime should provide a suitable degree of flexibility in order to ensure that the enormous value that derives from the existing diversity of execution models is not lost.

4. Concluding remarks

We appreciate the Commission's clear statement as to the challenges it has observed in commodity markets, including derivatives markets, and believe that the Commission is right to take concrete policy actions to further enhance transparency and ensure that regulators have the information and powers necessary to supervise these markets effectively. Evidence-based policy making will ensure that commodity derivative markets continue to play a vital role in supporting the real economy.

Yours faithfully,

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ISDA, which represents participants in the privately negotiated derivatives industry, is among the world's largest global financial trade associations as measured by number of member firms. ISDA was chartered in 1985, and today has 800 member institutions from 54 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities.

Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business. Among its most notable accomplishments are: developing the ISDA Master Agreement; publishing a wide range of related documentation materials and instruments covering a variety of transaction types; producing legal opinions on the enforceability of netting and collateral arrangements (available only to ISDA members); securing recognition of the risk-reducing effects of netting in determining capital requirements; promoting sound risk management practices, and advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives.