ISDA® Safe, Efficient Markets

13 July 2011

Regulation in Commodity Derivatives markets within MiFID

Introduction

ISDA welcomes the ongoing debate on the regulation of commodity markets to the extent that it is aimed at improving their functioning, allowing regulators to tackle market abuse and providing the appropriate level of transparency.

ISDA is clear in its view that rising prices of commodities, in the energy sector as well as food commodities, can have a significant detrimental impact on consumers and also on producers alike, in both developed and in developing countries, with greater impact often felt in emerging economies. The seriousness of these developments makes it all the more important that the debate around commodities markets is based on objective evidence and dispassionate analysis.

ISDA also recognises that the world's rising population in the coming decades (from 6bn people in 2010 to an estimated 9bn people in 2050), will imply ever-increasing demands on limited resources and provide a challenge for industrial producers, market intermediaries, policy makers, governments and international organisations, including the G20.

Therefore ISDA, on behalf of its members (who include financial institutions, commodity firms and institutional investors), would like to take this opportunity to set out its views on the various upcoming European legislative proposals, particularly the Markets in Financial Instruments Directive (MiFID) which will seek to address the future regulation of commodity derivatives markets.

Specifically, ISDA welcomes the anticipated extension of the scope of the existing Market Abuse Directive (MAD) to cover Multilateral Trading Facilities (MTFs), a broader but appropriately calibrated trade transparency regime under the MiFID review and the creation of a market abuse regime for physical EU power and gas markets (REMIT). In this context, ISDA welcomes REMIT as an important step towards greater convergence between financial regulation and gas and power regulation by setting out rules to prohibit the misuse of inside information through proposals that are tailored to the underlying physical gas and power markets but which are nevertheless largely consistent with MAD.

Lastly, ISDA recognises the political calls for action in relation to commodity price increases. We also recognise that further regulation of commodity markets will be forthcoming within MiFID and MAD. While we support these in principle, we believe that regulatory measures should be proportionate, appropriate and targeted at identifiable and measurable policy goals. Indeed, ISDA notes that in the long run the principal driver of rising price levels is the rapid escalation of marginal production costs and that measures seeking to regulate commodity markets will not solve these fundamental issues. The Annex gives a list of the reports showing the fundamental drivers of commodity prices.

ISDA would also like to highlight its membership's view that regulation should be tailored to address the specific risks posed by a particular commodity derivatives market and its respective participants and that any change in the regulatory framework should not lead to unintended consequences. ISDA is especially concerned that any proposal centred on establishing a position limits-based regime could significantly reduce market liquidity by limiting the capacity of many market participants to enter into transactions in commodities.

ISDA would highlight that a reduction in essential market liquidity is likely to harm price discovery and efficient risk management and accordingly have a broader economic impact.

ISDA believes it would be useful to make a distinction between two categories of regulatory principles: those related to markets and those related to market participants.

Regulation applicable to markets

ISDA reiterates the importance of the upcoming regulatory reforms being applied appropriately and proportionately.

- ISDA supports the implementation of tailored rules targeting ***market abuse*** as long as a proper definition of inside information is applicable to the physical markets and to commodity derivatives markets. ISDA believes that market abuse in the underlying physical commodity markets is best addressed by tailored regulatory measures, such as REMIT for gas and power markets. ISDA is of the opinion that is it essential that financial and physical markets regulators coordinate their action at the international level to be able to properly detect and address market abuse.

- As regards MiFID, ISDA considers it critical to distinguish between trade information that is provided to regulators so they are able to discharge their supervisory functions effectively – regulatory transparency – and trade information that is made available to the public – public or trade transparency.

- ISDA considers it essential that any extension of ***post-trade transparency requirements to commodity derivatives under MiFID is*** appropriately and carefully calibrated, taking account of the specific nature of the particular commodity and market, which means in practice recognising the important role played by intermediaries who anonymously warehouse risk, thus enabling end-users to effectively lay off the risks that arise from their own commercial activities.

- On the other hand, ISDA does not believe that further ***pre-trade transparency*** requirements are either necessary or appropriate in the commodity derivatives markets as defined in MiFID.

  As a result of the exclusively wholesale nature of the markets, market participants already have access to pre-trade transparency mechanisms, including those arising from the large number of commodity derivatives exchanges and MTFs (most trades will be priced via a visible benchmark). ISDA is of the view that the impact of reduced market liquidity and increased production costs to market participants and their customers arising from increased pre-trade transparency would likely be disproportionate to the potential benefits.

- In terms of ***transparency to the regulators***, we support transparency via trade repositories and position reports, which enable regulators to access trade and position data.

ISDA highlights that, as part of its continuing efforts to improve transparency in the over-the-counter (OTC) derivatives markets, the ISDA Commodities Steering Committee has chosen Depository Trust & Clearing Corporation (DTCC) Deriv/SERV and EFETnet to partner with the Committee on the development of a new Commodity Derivatives Trade Repository. The repository will be designed to meet current and anticipated regulations governing trade repositories and will provide a structure to rapidly report and provide timely access to information to relevant regulators.

ISDA strongly believes that trade repositories improve post-trade transparency by providing regulators globally with significant visibility of risk exposures by firm and by counterparty. ISDA has helped to establish trade repositories for other asset classes, including OTC credit, interest rate and equity derivatives, and is of the view that these repositories are an increasingly important tool for regulatory transparency.

- We support the regulatory initiatives to improve the transparency and availability of fundamental data[1] for the underlying physical commodity markets which impact market prices. Transparency of fundamental data will help improve functioning of the relevant commodity market and its price formation processes.

- Lastly, ISDA is of the view that commodity derivatives markets should be properly supervised and strongly believes that appropriate ***supervision*** is as important as effective regulation.

Regulation applicable to the market participants

ISDA considers that commodity derivatives market participants should be subject to appropriate rules on the clearing of OTC derivatives and to conduct of business rules that take into account the wholesale nature of these markets. One aspect of ensuring this is to maintain the current definition of professional investors in MiFID and the existing client classification arrangements.

- As regards ***capital requirements***, ISDA believes that it would not be appropriate to apply to commodity derivatives firms the same rules that apply to credit institutions. There is a clear need to consider the capital treatment of commodities derivatives firms in tandem with legislation under review (MiFID, EMIR, REMIT, MAD, CRD IV). The CRD exemption for specialised commodity derivatives trading firms should be kept until the CRD review is completed and the key parameters of a prudential regime to cover commodity derivatives firms have been established.

[1] Fundamental data is the information which has an effect on the price formation process for commodities (e.g. oil and gas products), such as information on production / generation, transmission, storage and consumption.

- As regards ***position limits***, ISDA understands that the European Commission is minded to support the introduction of such provisions within EU legislation and would take this opportunity to make the following points:
  - ISDA notes that position limits were originally imposed in exchange-traded commodity derivative markets as a tool for ensuring that large positions were not amassed as the expiry of a physically-delivered contract approached. This approach has two principal aims:
    - Firstly, limiting concentrated and dominant positions reduces the risk of a "market squeeze".
    - Secondly, limits assist in maintaining market confidence and integrity by preventing participants from incurring obligations to accept or deliver large quantities of physical commodities where they are not equipped to do so.

    These limits may be set by regulators or by the exchanges on which the contracts are traded, depending on the contract and the regulatory regime in question. ISDA observes that there is no conclusive study which support the assertion that position limits will either contain upward price movements in derivatives (or their associated underlying), or that they will more broadly deter manipulative practices. In the case of a number of markets where position limits already apply, there is no evidence which suggests that positions limits have brought about a reduction in volatility or price movements compared to contracts that aren't subject to such limits.
  - ISDA strongly believes that any position limit regime will create arbitrary limits to participants' activity and consequently restrict the ability of commercial users to hedge their risks. Positions limits assume that market activity should be limited to a 'natural' size and that activity greater than this amount is not legitimate business but manipulative. This is a false assumption as hedge risks ebb and flow. Consequently the ability to manage those risks should also be fluid.

    Financial institutions provide volume and liquidity to the markets, which facilitates accurate price discovery and stability. These institutions are able to act as risk warehouses facing both producers and consumers developing customised hedge solutions for these clients, with the institution managing its net exposure on the appropriate exchange. Position limits would adversely impact these relationships as they would likely reduce the ability of the financial institution to manage its exposure to its clients and consequently reduce the availability of risk management tools. Positions limits for different types of activity are arbitrary in nature and place unnecessary constraints on activity and are difficult to monitor and enforce. For example, motivations for activity can be difficult to interpret; for instance, is a farmer who over-hedges his production hedging or speculating or both?

Inappropriate limits during the spot month would force participants to exit positions, which would likely adversely impact end-users who have good commercial reasons to hold these positions. This will also potentially result in aberrational effects on market pricing as participants are forced to exit.

- The international nature of most commodity markets argues against local position limits. Energy commodities are essentially fungible products and the imposition of position limits for energy commodities traded on a country or on a regional basis could significantly impact the trading volume in those markets, without having any effect on overall global market volumes. Thus local market participants may be unable to manage their price risk effectively and be subject to prices that could disconnect from the global market at key times in the contract cycle.
- Also, there is a multitude of legitimate activity that occurs in commodity markets that the implementation of position limits could harm with detrimental effects on the whole market.
- ISDA would highlight that imposition of position limits is also likely to exacerbate the existing delays to price transmission between markets, an issue already identified by the Commission as needing addressing.
- Lastly, some financial institutions which are active in physical markets hedge other participants' risks or provide risk management solutions to their institutional clients; each of these activities is separately managed and controlled and aggregating them into a single position and subjecting that to a limit would be inappropriate.

- ISDA believes that the optimal regulatory approach would be to favour ***position management*** instead of position limits and allow each regulated market to determine the appropriate position management tools to maintain order on its markets.

  So, for example, holders of large positions on the London Metal Exchange are required from time to time to lend metal into the market at fixed rates to maintain an orderly delivery process, thus preserving market integrity.

  ISDA notes that a position management approach provides the regulator with information on market concentration while providing market users with the flexibility to manage risks appropriately.

- **ISDA strongly believes that position management is a more appropriate and effective tool for dealing with market manipulation risks than position limits, as these measures can be tailored to the contract concerned and have been shown to be effective in preventing market abuse**. This approach gives regulators the ability to intervene at any time in the contract life cycle no matter the size of the position; thus position management gives regulators much more flexibility. For instance, with a position management approach, market participants such as members of exchanges are required to abide by the position reporting requirements as set out by regulators or in the rules of an exchange. These requirements give the regulators and/or exchanges authority to manage positions at any time throughout a contract's

life cycle and to instruct a participant to close or reduce a position, if that is necessary, to secure fair and orderly markets. If the participant does not comply, the regulator/exchange has the power to close the position unilaterally. A position management approach takes account of contract liquidity as well as the scale and nature of participants involved at any given point in time; this is not necessarily the case with a position limit regime.

ISDA therefore urges the European Institutions to be flexible and to consider the implementation of position management instead of setting position limits.

ISDA looks forward to maintaining a regular and constructive dialogue with regulators and policy makers on the commodity regulation agenda and to help in any possible way.

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Annex - Fundamental drivers of Commodity prices and price volatility

ISDA acknowledges the urgency of the need to address the fundamental drivers of higher commodity prices and price volatility.

The principal mid- and long-term driver of rising price levels is the rapid escalation of marginal production costs. These rising costs are the direct consequence of strong and sustained emerging market demand growth exhausting spare capacity and forcing investment in costlier and ever more difficult to access sources of supply.

It is critical that regulators and market participants acknowledge the impact of these costs.

Many examples could be identified and ISDA notes that several public reports set out evidence of these mid- and long-term drivers:

- **European Central Bank**, Working Paper Series, **June 2011**, "***do financial investors destabilize the oil price?***", highlighting that: "*Financial investors in the futures market can destabilize oil spot prices, although only in the short run (…). However, shocks to oil demand and supply remain the main drivers of oil price swings* (p. 4)"; "*the destabilizing financial shock only explains about 10 percent of the total variability in oil prices, and shocks to fundamentals are clearly more important*" (p. 5);
- **European Commission, DG Agriculture and Rural Development**, report on "***High commodity prices and volatility … what lies behind the roller coaster ride?***", **June 2011**, highlighting that "*changes to the fundamentals of agricultural markets, e.g. higher yield variability, rising demand and growing sensitivity to stock changes are all factors which contribute to upward pressure on prices and explain to a large extent the increase in price volatility*". This report calls for further study of other factors, such as fluctuations in demand for agricultural non-food commodities, increasing correlation between oil and agricultural markets, and linkage with financial investment, but does not support the idea that financial activity could be a main driver;
- **FAO, IFAD, IMF, OECD, UNCTAD, WFP, the World bank, the WTO, IFPRI and the UN HLTF** report on "***Price volatility in food and agricultural markets: policy responses***", 3 May 2011, highlighting that "*Most agricultural markets are characterized by a high degree of volatility. Three major market fundamentals explain why that is the case. First, agricultural output varies from period to period because of natural shocks such as weather and pests. Second, demand elasticities are relatively small with respect to price and supply elasticities are also low, at least in the short run. In order to get supply and demand back into balance after a supply shock, prices therefore have to vary rather strongly, especially if stocks are low. Third, because production takes considerable time in agriculture, supply cannot respond much to price changes in the short term, though it can do so much more once the production cycle is completed.*" (p. 8)
- **United Nations Conference on Trade and development (UNCTAD) and Arbeiterkammer Wien** report on "**Price formation in financialized commodity**

markets", June 2011, highlighting that "*Price volatility has long been recognised as a major feature of commodity markets. Commodity specific shocks, especially on the supply side of food commodities, have generally played a key role in this respect. Rapidly growing demands for commodities, especially in emerging economies, as well as the debate about the future use of fossil fuels in the light of global climate change, and about the link between agricultural production and climate change more generally, have clearly had an impact on recent commodity price developments beyond simple commodity-specific shocks*." This report also points out the role of financial activity in the short-term but does not conclude that financial activity could be a driver of mid- and long-term high level prices.

ISDA would be glad to share views and materials on the drivers of commodity prices and to demonstrate that financial markets efficiently provide for hedging of physical production costs.

ISDA would also like to give one illustrative example relating to oil markets:

Petrobras reports that the well depths of its key oil discoveries offshore Brazil have increased from 4,343m in 2003 (Roncador) to 7,000m in 2007 (Tupi), a 12.7% annual compound growth rate. At the same time, conventional discoveries are becoming scarcer: the global count of shallow water wells dropped by 25% between 2005 and 2009, despite the increase in oil prices.

Rising marginal production costs in energy in turn raise production costs for most other commodities (e.g. diesel fuel used by farm equipment to harvest wheat). As rising costs drive market price levels higher, volatility remains proportional to price in percentage terms; however, by definition this means that price swings in absolute terms ($/bbl) are larger than before. With fixed costs relatively high, larger swings in revenues mean even average cost and low cost producers have greater incentives to hedge than before. Combined with the hedging needs of the high-cost producers who are bringing new marginal supplies to meet new demand, this creates a rapid increase in the volume of offered hedges. These hedges allow optimization of free cash flow and working capital, while protecting the hedged enterprises in the event of very large and inherently unpredictable price moves (such as the volatility in oil prices spurred by the Libyan Civil War and the strong price decline that followed the Japanese earthquake one month later).

Consumers and investors willingly take the other side of the hedges the producers wish to make, as doing so enables them to hedge their own risks. This insurance transaction is beneficial to all involved parties and to the general public. Good policy should focus on the investment requirements necessary to expand spare production capacity and lower marginal and average production costs.

Over time, greater production capacity will significantly reduce both market prices and price volatility. Good policy should also focus on protecting the financial tools used to manage capital expenditure hurdle rates and earnings volatility, including the vital liquidity and patient capital supplied by investors. Ill-conceived policy that choked the provision of this valuable insurance during the unavoidable period before new spare capacity is available would not lower prices, but it would depress liquidity and thus increase volatility relative to any given level of price. It would also increase the risks borne on the balance sheets of the producers who are being asked to meet global demand.