International Organization of Securities Commissions

Technical Committee

Report of the Task Force on Commodity Futures Markets

Executive Summary

The IOSCO Task Force on Commodity Futures Markets was formed following the concerns expressed by the G-8 Finance Ministers regarding the price rises and volatility in agricultural and energy commodities in 2008. The Task Force has made the following conclusions and practical recommendations:

- Reports by international organizations, central banks and regulators in response to the above concerns that were reviewed by the Task Force suggest that economic fundamentals, rather than speculative activity, are a plausible explanation for recent price changes in commodities. However, given the complexity and often opacity of factors that drive price discovery in futures markets, and the critical importance of these issues to world economies, continued monitoring is appropriate to improve understanding of futures market price formation and the interaction between regulated futures markets and related commodity markets[1].

[1] The term "related commodity market" refers broadly to the cash commodity that underlies the futures contract, as well as positions in privately negotiated transactions involving the same commodity that are not traded on a regulated exchange (e.g. forward contracts, swaps, options and other structured products). The purpose of enhancing the transparency of related information is to assist in determining whether market abuses may be taking place in the regulated futures market. Correspondingly the term "underlying" commodity market refers solely to the physical/cash market.

- The Task Force has identified factors that potentially inhibit the ability of commodity futures market regulators ("futures market regulators")[2] to access relevant information concerning the related commodity markets,over which futures market regulators generally do not have authority, that may be needed to understand fully price formation in a particular futures market contract or to detect manipulative or other abusive trading by market participants holding large positions in those commodity contracts. Accordingly, the Task Force is calling for transparency improvements with respect to the availability and quality of information on commodities that are intended to improve the ability of futures market regulators to:

    - understand with greater clarity the role of speculative and commercial activity in commodity futures markets;
    - gain a more comprehensive view of trading activities in, and the structure of, the related commodity markets that may affect price formation on commodity futures markets; and
    - detect, prosecute[3], and deter manipulation and other trading abuses in commodity futures markets, which may involve related commodity markets.

[2] The term "commodity futures market regulator" ("futures market regulator") is intended to refer specifically to the regulator of the commodity futures markets. Because regulatory structures vary across jurisdictions (e.g., enforcement and supervisory responsibilities with respect to futures markets may reside in different entities), the recommendations in this report should be read in a manner that is consistent with, and appropriate to, a particular jurisdiction's regulatory structure. However, the recommendations are not necessarily intended to only apply to futures market regulators, but also may apply to self-regulatory organizations or an exchange or both where the context permits.

[3] The term "prosecution" is used in a wide sense for the purposes of this report. It covers all types of enforcement action against manipulation and other market abuse practices, including imposition of administrative fines or the referral of a case to the public prosecutor.

- Further, to respond to the increasingly global nature of commodity markets, the Task Force encourages cooperation and the sharing of information among futures market regulators. The Task Force recommends that the Technical Committee re-endorse to the IOSCO membership and to relevant non-IOSCO stakeholders the continued relevance of the Tokyo Communiqué and that futures market regulators should evaluate their oversight programs for compliance with the Tokyo Communiqué guidance.

- Manipulation of market price is a clear threat to the integrity of the marketplace and to the key price discovery and risk management role that futures markets play in the larger economy. Because manipulative schemes are often complex and may involve conduct that takes place on commodity futures, OTC derivatives and physical commodity markets located in one or more jurisdictions, the Task Force is calling for futures market regulators to review their existing powers to ensure that they have the necessary legal framework that is able to provide an effective enforcement deterrent.

    - Among other things, the Task Force recommends that futures market regulators review powers and, if necessary, take appropriate steps to promote improvements or eliminate existing impediments in their legal and regulatory framework that may inhibit their ability to detect and enforce manipulation cases, such as the inability to access certain market information, the inability to enforce against attempted manipulation and the inability to investigate unregulated entities.

    - A key recommendation is that futures market regulators should have sufficient resources for an enforcement program that specifically targets manipulative and abusive trading conduct.

- Finally, in order to enhance the sharing and coordinating of surveillance and enforcement techniques, the Task Force recommends that futures market regulators meet regularly for the purpose of informal sharing of their perspectives and concerns on trends and developments in commodity markets as well as the sharing of market surveillance and enforcement approaches.

Background

The Task Force on Commodity Futures Markets[4], which is co-chaired by the United States Commodity Futures Trading Commission (CFTC)[5] and the United Kingdom's Financial Services Authority (FSA)[6], was created in September 2008 by the Technical Committee of the International Organization of Securities Commissions (IOSCO). IOSCO initiated the Task Force following political, academic and media debate concerning the behaviour of commodity markets, both financial (i.e. the regulated commodity futures markets) and underlying (i.e. cash), in a period which has seen considerable price rises in certain commodities and increased market volatility.

[4] The following IOSCO members participated in the Task Force: Comissão de Valores Mobiliários (Brazil); Ontario Securities Commission (Canada, Ontario); Autorité des marchés financiers (Canada, Quebec); Dubai Financial Services Authority (Dubai); Autorité des marchés financiers (France), Bundesanstalt für Finanzdienstleistungsaufsicht (Germany), Securities and Futures Commission (Hong Kong), Commissione Nazionale per le Società e la Borsa (Italy), Ministry of Economy, Trade and Industry (Japan); Kredittilsynet (Norway), Eidgenössische Bankenkommission (Switzerland); Financial Services Authority (United Kingdom), Commodity Futures Trading Commission (United States).

[5] The Commodity Futures Trading Commission (CFTC) was created in 1974 as an independent agency with the mandate to regulate commodity futures and option markets in the United States. The agency's mandate has been renewed and expanded several times since then, most recently by the CFTC Reauthorization Act of 2008.

[6] The Financial Services Authority (FSA) is an independent non-governmental organization responsible for regulating financial services in the UK with statutory powers given by the Financial Services and Markets Act 2000.

The G-8 Finance Ministers also raised strong concerns at their June 2008 Meeting in Osaka, Japan, about the sharp rise in oil and food prices and the impact on global macro-economic stability as well as people's welfare and development prospects. The G-8 Finance Ministers specifically called for "national authorities to examine the functioning of commodity futures markets and to take appropriate measures as needed."[7] The Task Force's work accordingly has been conducted in the light of this debate.

Responding to these concerns, the Task Force held meetings in Washington, DC in December 2008 and in London in January 2009. The group focused on the following topics:

- Volatility and the role of new participants in futures markets;
- Transparency and market surveillance;
- Challenges to enforcement; and
- Enhancing global cooperation.

The primary focus of the Task Force was whether supervisory approaches were keeping pace with market developments, including the participation of new categories of traders such as index funds, whether transparency in commodity markets was sufficient in light of current concerns, and whether supervisory and enforcement cooperation could be improved.

[7] Statement of the G-8 Finance Ministers Meeting, Osaka, Japan (June 14, 2008).

Therefore, the Task Force members took the opportunity to review further the appropriateness of their regulatory toolsets for the commodity futures markets for which they have responsibility. However, the Task Force also considered the wider commodity markets, including the related markets for which, in the main, its members do not have oversight responsibility.

Given this background, the Task Force's recommendations relate to both regulated futures markets and related commodity markets. Certain of these related commodity markets may be regulated and/or supervised by an authority that is separate from the futures market regulator and co-ordination with the appropriate authority is important in this regard. The Task Force acknowledges that futures market regulators in different jurisdictions have different responsibilities and powers and that its recommendations will not apply equally to all. Accordingly, the Task Force recommendations should be read in this light.

Discussion

Volatility and the Role of New Participants in the Futures Markets

The extent to which speculative activity by new participants (e.g., index funds) [8] in agricultural and energy commodity futures contracts[9] and economic fundamentals have each contributed to

[8] Commodity index funds, which invest in commodity futures contracts, have increasingly been used by pension funds and other large institutions as a means to obtain greater diversification in their investment portfolios.

[9] Particularly the oil and natural gas markets were the focus of the debate about energy commodities.

extreme price movements and volatility in the underlying *physical* commodities has been a matter of intense political and academic debate.[10]

In light of the practical focus of the Task Force as well as resource and time constraints, the Task Force did not attempt to conduct original research on cash and futures market data or to evaluate comprehensively the universe of studies and reports that have been conducted on this issue. Instead, the Task Force relied primarily on reviews that were conducted in 2008 by the International Monetary Fund ("IMF") staff, the European Commission ("EC"), HM Treasury and the US Inter-Agency Task Force chaired by staff of Commodity Futures Trading Commission, as they provide a representative sampling of how available evidence has been interpreted.

The reports reviewed by the Task Force do not support the proposition that the activity of speculators has systematically driven commodity market cash or futures prices up or down on a sustained basis. These reports suggest that economic fundamentals, rather than speculative activity, are a plausible explanation for recent price changes.

An analysis of available data is found in the IMF's October 2008 World Economic Outlook Survey ("*IMF World Economic Outlook*"). The IMF Economic Outlook specifically examined

[10] *See e.g.* the discussions on Professor Paul Krugman's economics blog at http://krugman.blogs.nytimes.com/2008/06/21/calvo-on-commodities/, http://krugman.blogs.nytimes.com/2008/06/24/speculation-and-signatures/ and http://krugman.blogs.nytimes.com/2008/06/26/speculate-speculate/. See also Professor Guillermo Calvo at http://www.voxeu.org/index.php?q=node/1244 (excess liquidity caused by low interest rates drove prices).

"whether the recent commodity price boom had been underpinned by the rapid rise in investment in commodity-indexed assets" and concluded that:

> *Despite recent financial innovation in commodity markets, such as indexing, which has allowed investors to benefit from rising commodity prices without having to maintain physical inventory holdings, there is little discernable evidence that the buildup of related financial positions [in commodity markets] has systematically driven either prices for individual commodities or price formation more broadly.* [11]

In reaching this conclusion, the *IMF World Economic Outlook* considered studies using time-series analyses that examined whether changes in commodity financial positions led to commodity price changes and noted that such recent studies "have not found evidence of systematic causality between positions and prices in either direction."[12] The IMF staff considered studies that examined inventory behavior and observed that "the data suggest that although inventories for some commodities increased somewhat in recent years, inventories for other commodities that had significant price appreciation declined or remained broadly stable."[13]

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[11] *World Economic Outlook*, Chapter 3 p.87, International Monetary Fund (October 2008), http://www.imf.org/external/pubs/ft/weo/2008/02/index.htm

[12] IMF *World Economic Outlook*, Chapter 3 p.89. On the contrary, the studies in question found that "the direction of financial flows was often inconsistent with the direction of price movements. For example, while crude oil prices rose sharply in May and June 2008, net speculative positions declined."

[13] IMF *World Economic Outlook*, Chapter 3 p.89. These inquiries posit that in order for financial market speculation to have a systematic effect on commodity prices, it must be accompanied by an increase in hoarding of physical inventories. Although the IMF concluded that, there is little evidence of a systematic inventory hoarding of commodities, it added a caveat "that data on commodity inventories are poor and lack global coverage."

With respect to inventories, the U.S. Inter-Agency Task Force found that "U.S. inventories for crude oil and gasoline were very low during the first half of 2008. Weekly data since June 2008 indicates that U.S. crude oil and

Finally, the *IMF World Economic Outlook* examined the relationship between "financialization" of commodities (*i.e.* the increased commitment by investors to commodities as an asset class) and price levels, volatility and price co-movements across markets and stated that:

> *Although financialization may have led to increases in co-movement between some commodities, particularly gold, no apparent systematic connection is found to either price volatility or price changes. These findings are consistent with recent studies in the area by the CFTC. Thus, there is little evidence to suggest that trading in futures markets has driven the price run-up or has destabilized the commodity markets during the first half of 2008.* [14]

Overall, the *IMF World Economic Outlook* concluded that "*the current commodity boom has, broadly speaking, reflected the interaction of strong demand, low inventory and spare capacity levels, slow supply expansion in key sectors and adverse supply shocks."* [15] Fundamental factors were viewed as similarly driving the drop in oil prices.[16] Although the *IMF World Economic*

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gasoline inventories rose to near normal levels, though gasoline stocks have fallen dramatically due to the effects of Hurricanes Gustav and Ike." *The Inter-Agency Task Force on Commodity Markets* (July 2008) at p.8.

[14] IMF *World Economic Outlook*, Chapter 3 p.92. International Monetary Fund (October 2008). This study cautioned that "given the inter-linkages among commodities, it is possible that financialization could affect Group B indirectly through Group A . . . ."

[15] IMF *World Economic Outlook*, Chapter 3 pp.83-84. International Monetary Fund (October 2008)

[16] The IMF Economic Review concluded that: "Oil prices have eased recently on (1) increased OPEC production (primarily in Saudi Arabia); (2) data signaling a continued decline in U.S. demand that seems to reflect a growing demand response to high prices and not just slowing income; (3) prospects for lower growth in other major advanced economies; and (4) less-supportive financial conditions." *World Economic Outlook*, Chapter 3 p. 96. International Monetary Fund (October 2008)

Outlook concluded that there was no evidence of long term systematic effect due to speculation on commodity prices, it suggested that "short term expectations can be influenced by sentiment and investor behavior, which can amplify short-term price fluctuations, as in other asset markets." [17]

An EC report similarly concluded that "both the oil price increases seen in recent years and the price fall over the past weeks have been mainly driven by demand and supply factors."[18] In discussing the growing political concern that financial market speculation has driven oil prices to artificially high levels (*i.e.* beyond the level justified by market fundamentals) the EC Report first distinguished between two types of speculation: the first type of speculation was described as being:

> *linked to the expected evolution in market fundamentals, which it characterized as an essentially positive feature of the market, facilitating price discovery and risk management for the investor, while providing a timely signal of the need for adjustments in structural supply and/or demand in the market.…The second type of speculation can*

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[17] "Because most commodities are storable, they are real assets, and their prices are thus affected not only by current market conditions but also by future expectations. " *IMF Economic Outlook* at p. 87 (October 2008). *See Oil Prices: the True Role of Speculation*, Noel Amnec, Benoit Maffei and Hilary Till, EDHEC Risk and Asset Management Research Centre (November 2008) at p. 27, which cited studies that assert a short term interaction effect between futures trading and cash prices. The *HM Treasury Report* observed that futures market signaling about future expectations can influence a producer's decision whether to hold on to stocks, which decision could in turn feed through to the spot price. *See Global Commodities: a long term vision for stable, secure and sustainable global markets* (June 2008) at p. 24.

[18] *First Interim Report on Oil Price Developments and Measures to Mitigate the Impact of Increased Oil Prices*, European Commission (1 September 2008) ("EC Report")

result in the emergence of a speculative bubble, reinforcing the fundamentals-based (and usually upward) price trend….

W*hile the first and favourable type of speculation certainly has contributed to the recent surge in oil prices, there is little evidence of the second, more detrimental type of speculation.*[19]

An HM Treasury report reached similar conclusions.[20] As observed by HM Treasury:

Nevertheless, taken together the available evidence suggests that derivative investors are not driving price increases and, although there is insufficient evidence to conclusively rule out any impact, it is likely to be only small and transitory relative to fundamental trends in demand and supply for the physical commodities.

Preliminary CFTC staff studies conducted for the U.S. inter-agency task force ("ITF") did not find evidence that various categories of financial participants, either individually or as a whole,

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[19] *Id*. at p. 5-6. In effect, the conclusion supports the view that the futures markets were in fact operating as price *discovery* markets. *See also* "*How Should We Respond to Asset Bubbles*" by Governor Frederic S. Mishkin, Board of Governors of the United States Federal Reserve System (May 15, 2008) on the difficulty of identifying asset bubbles and possible policy approaches. http://www.federalreserve.gov/newsevents/speech/mishkin20080515a.htm

[20] *See Global Commodities: a long term vision for stable, secure and sustainable global markets* HM Treasury, (June 2008) at p. 25. http://www.hm-treasury.gov.uk/d/globalcommodities.pdf

See also Oil Prices: the True Role of Speculation, Noel Amnec, Benoit Maffei and Hilary Till, EDHEC Risk and Asset Management Research Centre (November 2008). http://www.edhec-risk.com/features/RISKArticle.2008-11-26.0035. This paper argues that "despite the appeal of blaming speculators, supply-and-demand imbalances, the fall of the dollar and low spare capacity in the oil producing countries were the major causes of the initial sharp rise."

were systematically driving commodity prices.[21] The ITF's studies relate to price movements and focus on whether various groups or subgroups of traders trade in advance of price movements or in response to past price movements. The empirical regularity disclosed by these studies is that financial participants do not trade in advance of price changes, but rather trade in response to past price changes. The staff interim report noted, however, that it was preliminary in nature and that further study of the crude oil market would continue as part off its longer term activities.

The Task Force recognizes that there has been controversy surrounding the interaction between futures market trading and underlying commodity market prices. Such controversy is likely to continue due to the broad economic impact of price increases in basic commodities, the complexities of markets and data limitations. For example, as observed in the HM Treasury Report, "there remains a need for sufficient information on financial flows into commodity derivatives to ensure an accurate understanding of market developments.[22] Finally, public scrutiny likely will continue to focus on regulated futures markets because they operate in a

[21] *The Inter-Agency Task Force on Commodity Markets* (July 2008) concluded that: "The Task Force's preliminary assessment is that current oil prices and the increase in oil prices between January 2003 and June 2008 are largely due to fundamental supply and demand factors. During this same period, activity on the crude oil futures markets – as measured by the number of contracts outstanding, trading activity, and the number of trades – has increased significantly. While these increases broadly coincided with the run-up in crude oil prices, the Task Force's preliminary analysis to date does not support the proposition that speculative activity has systematically driven changes in oil prices." The staff report is preliminary in nature and the ITF is continuing to study the crude oil market as part of its longer term activities.
http://www.cftc.gov/stellent/groups/public/@newsroom/documents/file/itfinterimreportoncrudeoil0708.pdf

[22] *See Global Commodities: a long term vision for stable, secure and sustainable global markets* HM Treasury, (June 2008) at p. 25. http://www.hm-treasury.gov.uk/d/globalcommodities.pdf See also the limitations that should be taken into account when interpreting the analyses contained in the *Interim Report of the US Inter-Agency Task Force on Commodity Markets* at pp. 28-29; and the acknowledgement in *Oil Prices: The True Role of Speculation* at fn 1 p. 37, that "ultimately, only dynamic frameworks will likely be satisfactory in comprehensively explaining the evolution of the price of crude oil during the first seven months of 2008."

highly transparent environment. In contrast, there has not been a similar focus on the drivers of the huge increase in prices of other cash commodities such as iron ore and other commodities which are not the subject of futures trading.[23]

Accordingly, continued monitoring of commodity markets is appropriate in order to address these concerns and to improve futures market regulators' understanding of futures market price formation and the interaction between, regulated futures markets and related commodity markets. Moreover, as discussed below, the Task Force is calling for certain transparency improvements that are intended to facilitate such monitoring. These transparency improvements may also enhance market participants' own ability to make decisions about market structure and price movements.

Greater transparency of commodity market fundamental information is needed

Commodity futures markets are price *discovery* markets,[24] in which the futures price tracks the prices of and signals information and expectations about the direction of the underlying markets.[25]

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[23] *See, e.g. IMF World Economic Review* at p. 91. "Indeed, many commodities without significant futures markets – such as iron ore and rice – have experienced more price appreciation than those with sizeable future markets, such as gold and crude oil." Other commodities that have experienced large price increases but which are not the subject of futures trading include manganese, cobalt, cadmium, rhodium, tungsten, coal and onions.

[24] *See The Need for Transparency in Commodity and Commodity Derivatives Markets*, Piero Cinquegrana, European Capital Markets Institute (ECMI) (2008) at p. 17 *et al* for a discussion of the social utility of futures markets price

The quality of the price which the futures market discovers reflects the extent of the market's understanding of the available underlying data, and the quality of that data. If data is inadequate or of poor quality it makes it difficult for futures market regulators to determine accurately whether or not certain activity or price movements are unusual. Accordingly, information about the underlying commodity is key for the satisfactory functioning of the futures market and reliable price discovery. [26]

Inquiry into the price formation process similarly can benefit from more comprehensive fundamental information in order to understand better the interactions between futures and the cash markets. For example, as previously noted, the IMF World Economic Outlook observed that with respect to hoarding studies, *"data on commodity inventories are poor and lack global coverage."* [27] As noted by HM Treasury, *"greater transparency across all parts of the commodity market – from information on harvest predictions to local farmers through to the*

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discovery function and the need for greater commodity market transparency. In arguing for more transparency, the author notes that in addition to increasing the informational efficiency of futures markets, *"heightened transparency would enhance the disclosure of financial risk."*

[25] As noted by Till in the EDHEC report at p. 26: *"In the absence of key (timely) fundamental data from non-OECD countries, one can rely on the transparency of commodity futures markets to infer what concurrent and future expectations are regarding the oil supply-and-demand balance…"*

[26] Examples of underlying cash market data include published prices and indexes of cash market transactions, inventory and storage reports, crop reports, government data (e.g. cattle data in the US) and all other market information on a particular commodity. The cash market data are available either publicly or privately, usually through third party vendors. The cash market data is used by both market participants and regulators to assess both current and prospective economic conditions.

[27] *See* IMF World Economic Outlook at p. 89.

production capacity of the major energy producing countries – can also play a role in helping all sides gain a better understanding of trends in supply and demand."[28]

Futures market regulators should help to promote improvements in the underlying data to reduce market uncertainty and to understand better the fundamentals driving the market. In this regard the Task Force considers that working with existing international and domestic organizations, whether governmental or private, to improve data collection and dissemination, may be the most efficient and practical way to achieve transparency improvements.

RECOMMENDATIONS[29]

Underlying data

Futures market regulators should promote improvements in the availability and quality of information on commodities that are related to commodity futures in order to reduce market uncertainty and to understand the fundamentals driving the market. Efforts could include encouraging data providers to provide a greater level of detail to data that are already published. For example, it may be possible for certain data providers to publish not only aggregate inventory and storage data but regional data as well. There may also be improvements regarding the accessibility of data, such as making the data readily available on the Internet. For example, IOSCO could support efforts by its members from oil producing countries to work with national

[28] *Global Commodities: a long term vision for stable, secure and sustainable global markets* (June 2008) at p. 64.

[29] Throughout the report, the Task Force has not attempted to rate the recommendations provided in order of importance.

energy authorities to improve coverage of the Joint Oil Data Initiative. [30] IOSCO members could do further work suggesting improvements.

- Futures market regulators should support initiatives to promote transparency in the underlying market.[31]
- Futures market regulators should encourage market participants to publish appropriate information in an accurate and timely manner[32].
- Futures market regulators should encourage private organizations that collect relevant fundamental commodity information to adopt best practices and should evaluate what improvements are appropriate to enhance fundamental cash market data and develop recommendations for improvements.

OTC Data

[30] The Joint Oil Data Initiative (JODI) is a transparency initiative established in 2003 as a permanent mechanism by the Asia Pacific Economic Co-operation (APEC), the Statistical Office of the European Communities (Eurostat), the International Energy Agency (IEA), the Latin-American Energy Organization (OLADE), the Organization of Petroleum Exporting Countries (OPEC) and the United Nations (through the UN Statistics Division). More than 90 countries, representing more than 90 percent of global supply and demand, are now submitting data to the joint oil data initiative database. The data cover production, refining, demand and stocks of seven product categories: crude oil, LPG, gasoline, kerosene, diesel oil, fuel oil and total oil. JODI is a promising work in progress with great potential. See http://www.jodidata.org/WJODI.shtm

[31] For example, in December 2008, the US Securities and Exchange Commission approved revisions to modernize its oil and gas company reporting requirements to help investors evaluate the value of their investments in these companies. *See* final rule Modernization of Oil and Gas Reporting at 74 *Federal Register* 2158 (January 14, 2009).

http://www.sec.gov/news/press/2008/2008-304.htm

[32] For example, based on the recommendations of CESR and the European Regulators Group for Electricity and Gas, the European Commission is considering a market abuse regime and trading transparency, including recordkeeping for the electricity and gas spot markets. The analysis undertaken has indicated that an improvement of disclosure of "fundamental data" (e.g., data on production, storage and network capacity) is widely perceived as critical for the integrity of these markets. Improvements in this regard are being considered in connection with a market abuse regime.

- Futures market regulators should evaluate what improvements are appropriate to enhance access to, and the usefulness of, OTC derivatives market data and develop recommendations for improvement. [33]

Data dissemination

- Disseminators of cash market data are relied upon by markets and commercial users. Where appropriate, ways in which the reliability of this market data could be improved should therefore be considered. These could include requiring accountability for false and misleading data, encouraging the development of best practices and the increase of transparency of methodologies.

Transparency and Market Surveillance

As set forth in the IOSCO *Objectives and Principles of Securities Regulation* (2008) the three core objectives of securities regulation are: protecting investors, ensuring that markets are fair, efficient and transparent; and reducing systemic risk. Robust market surveillance and enforcement programs are needed to implement these objectives. The Task Force focused on enhancing the ability to detect, enforce, and deter manipulative and other abusive trading on commodity futures markets and on making recommendations with the objective of improving transparency in underlying commodity markets.

[33] In July 2007, the Chairman of the UK parliament's Treasury Select Committee indicated his intention to request that the Bank for International Settlements disaggregate their published data for commodities into separate classes to afford additional transparency.

The Task Force agreed that the Tokyo *Communiqué*, which sets out guidance on standards of best practice in contract design, surveillance and information sharing with respect to physical delivery futures markets,[34] continues to provide comprehensive guidance that may assist futures market regulators in building an effective market integrity program.[35]

The IOSCO Technical Committee specifically examined the *Tokyo Communiqué* and noted that the basic precepts of the surveillance and contract design guidance apply equally to exchange-traded futures, options on futures and options (derivatives) contracts on all types of commodities,

[34] In November 1996, following the revelations of huge losses at Sumitomo and the related adverse effects on the global copper markets, the CFTC and the UK SIB, along with the relevant Japanese authorities, the Ministry of International Trade and Industry ("MITI") and the Ministry of Agriculture, Forestry and Fisheries ("MAFF"), co-sponsored an international regulators' conference in London on physical delivery markets in international commodities. The London conference focused on the special problems that physical delivery markets pose for regulators and considered how contract design, market surveillance and international information sharing can reduce the potential for, and assist in the management of, manipulation and other market disruptions. The 17 countries participating in that meeting issued a Communiqué agreeing on certain basic principles of regulation and on a year-long work program.

That effort culminated on October 30 and 31, 1997. Representatives of regulators from 16 jurisdictions responsible for supervising commodity futures markets participated in a conference in Tokyo, Japan, jointly chaired by the CFTC, the Japanese MITI and MAFF and the UK FSA, and announced the completion of the work program contained in the London Communiqué issued in November 1996. At the end of the meeting, the regulators issued a communiqué (the *Tokyo Communiqué*) which, among other things, endorsed two guidance papers, one on best practices for the design and/or review of commodity contracts and another on market surveillance and information sharing. The guidances represent the first occasion on which regulators responsible for overseeing commodity derivatives markets have agreed to international standards for the supervision of these markets. *See Tokyo Communiqué* at http://www.cftc.gov/stellent/groups/public/@internationalaffairs/documents/file/oia_tokyorpt.pdf or http://www.meti.go.jp/policy/commerce/intl/tkyc.pdf

[35] Eight Task Force member agencies had participated in the development of the *Tokyo Communiqué.*

but recognized that the recommendations may need to be adapted depending upon the characteristics of the derivatives contracts traded on a particular market.[36]

Notwithstanding this prior action, the Task Force recommends that the Technical Committee re-endorse to the IOSCO membership and to relevant non-IOSCO stakeholders the continued relevance of the *Tokyo Communiqué* and that futures market regulators should evaluate their oversight programs for compliance with the *Tokyo Communiqué* guidance.

A key point contained in the *Tokyo Communiqué* that is highly relevant to contemporary surveillance concerns is the recommendation that authorities that are responsible for market surveillance should be able to access sufficient information about futures and related cash positions[37] in order to identify dangerous concentrations of positions, to evaluate overall composition of the market and to assess its functioning. Obtaining such information across these markets assists in determining a large trader's intentions in respect to a particular commodity[38].

[36] *The Application of the Tokyo Communiqué to Exchange-Traded Financial Derivatives Contracts* (IOSCO) (1998). "In developing surveillance regimes, market authorities may need to place different emphasis on the nature of the underlying reference commodity and differences in the size (e.g. large open interest, small open interest) and composition (e.g., ability of traders to make or take delivery) of the market." p. 4 With respect to the contract design guidance, market authorities "may need to place different emphasis on specific issues (such as delivery characteristics or cash settlement type) depending upon the nature of the underlying reference commodity and differences in the cash market p. 12.

[37] "Related positions" are positions in other markets that are somehow linked or tied economically to the positions in the regulated market, for example contracts on the same commodity or products having a pricing mechanism that is linked to the futures settlement price.

[38] *See also Oil prices: the True Role of Speculation* at pp. 26-27 ("the opaqueness in commodity derivatives trading is concentrated in the over-the-counter (off-exchange) derivatives markets.")

In this regard, and in response to some of the issues addressed by the *Tokyo Communiqué*, the IOSCO Technical Committee published a report *Guidance on Information Sharing*, which identifies information that may be relevant in addressing specific types of market events.[39] The type of information that potentially may be relevant for market oversight purposes was further developed in the Technical Committee's report *Multi-jurisdictional Information Sharing for Market Oversight* (IOSCO April 2007).[40] Depending on the links between specific commodity markets, this is an area in which the development of formal information sharing arrangements may be appropriate.[41]

In addition to outlining the types of information that may be useful to share when addressing cross-border surveillance concerns, the *Multi-jurisdictional Information Sharing Report* makes clear that parallel trading of derivatives [42] may present opportunities for market users to use

[39] *Guidance on Information Sharing* (IOSCO) (1997). The Guidance provides that in dealing with unusual price movements or market volatility, markets and regulators should be prepared to share the following information: (i) firms/customers controlling or owning the largest long/short positions in relevant securities or derivatives; (ii) concentration and composition of positions in the relevant securities or derivatives, including Firm positions or Customer positions, both on organized markets and in the OTC markets; and (iii) characteristics of related instruments, such as terms of the underlying cash market instrument or physical commodity, procedures for delivery or cash settlement, and deliverable supply of the relevant cash market instrument or physical commodity.

[40] *Multi-jurisdictional Information Sharing for Market Oversight* (IOSCO) (April 2007) at p. 11. Among the information cited as possibly being useful is: transaction information (e.g., details of trader's positions, large positions, and related underlying market positions): and inventory levels and locations of delivery stocks (details of related warehouse information).

[41] For example, in 2006 the CFTC and UK FSA signed an MOU to address cross-border market surveillance concerns with regard to the trading of linked oil contracts on futures exchanges in both jurisdictions.

[42] "Parallel trading" means for purposes of this paper when a derivatives contract traded in one jurisdiction is based on the same (or an almost identical) underlying asset (or measure) as a derivative contract traded in another jurisdiction.

parallel trading to engage in conduct that is illegal in one or both jurisdictions. For example, a manipulation scheme may involve trading in multiple markets – both financial and underlying.[43]

The goal of improving the ability of futures market regulators to access potentially useful information is not a blanket recommendation for the imposition of mandatory routine reporting requirements in all cases. However, futures market regulators may need jurisdiction to collect information from outside the directly regulated futures markets for surveillance or enforcement purposes (e.g. investigations into market abuse).

The objective of obtaining additional trader data across all markets is to reduce informational gaps. Therefore the intention is not for the data to be used to conduct market surveillance of those markets outside direct regulatory scope, but rather to determine whether or not potential manipulation or other market abuses may be taking place in the regulated commodity futures markets.[44] The determination of "usefulness" therefore will generally be made on a case-by-case basis, taking into account the specifics of the futures contract and its related cash markets.

[43] Cases involving such multi-market schemes were discussed by the CFTC and Kredittilsynet of Norway and illustrate the need for access to related underlying market information. An example of market manipulation involving several commodities derivatives markets is the production of electricity using coal, oil or gas in the EU, which triggers trades of carbon emissions. If a situation occurs where a small increase in position in the emission derivatives market gives a large increase in prices in the electricity market it would be possible to exploit this by taking positions in both markets. If the market price in the electricity derivatives market increases, and the position in the electricity derivatives market is subsequently reduced again at a higher price, a profit will result. The position in the emission market can then be reduced, potentially at minimal cost. Partial investigations in each derivatives market would not reveal evidence of the manipulation.

[44] This Report is not intended to suggest changes in jurisdiction over or regulatory approaches to unregulated markets or products. Those issues are within the mandate of IOSCO's Task Force on Unregulated Products and Markets.

For this reason, market surveillance must be resource sensitive because generally it is neither physically possible nor necessary to scrutinize every trade and/or every position in order to form an understanding of market action.[45] Moreover, futures market regulators should recognize the burdens and costs imposed on the requested entity. As observed in the *Multi-jurisdictional Information Sharing Report*, information sharing requests can result in information over-load and unnecessary burdens for both the requesting and requested entity if not carefully calibrated[46].

RECOMMENDATIONS

The following recommendations are intended to enhance commodity market transparency:

- Futures market regulators should have access to information that permits them to identify concentrations of positions and the overall composition of the market, including the authority to access a trader's related financial and underlying market positions. They should review the scope of their authority and if necessary take affirmative steps to request the necessary powers legislatively.

- Market surveillance should take account of a trader's related financial and underlying market positions.

[45] However, it should be understood that in an investigation for market manipulation, it often may be necessary to reconstruct the entire trading record.

[46] *See Multi-jurisdictional Information Sharing for Market Oversight* (IOSCO) (April 2007) at p. 7. "For information to be useful to the requester, it needs to be relevant, to arrive in useable form and to be obtainable on a timescale appropriate to the need. All information requests are resource-consuming for a requested authority, some of whom may have limited resources…."

- Because no futures market regulator will necessarily have all the information they may need to form a comprehensive understanding of price formation and market conduct in the markets under its jurisdiction immediately available to it all the time, futures market regulators must be prepared to share such information with their regulatory counterparts, both domestic and foreign.

- Futures market regulators should encourage the development of agreements with national authorities responsible for any relevant cash market commodities in order to facilitate the sharing of needed cash market information, and, where relevant, request the legal competence for cooperation with these authorities. Such formal arrangements should be augmented through informal sharing of supervisory concerns.

- Futures market regulators should be prepared to develop information sharing arrangements to address the parallel trading of derivatives contracts on exchanges in different jurisdictions where this appears to be appropriate due to links betweens the specific commodities markets.

- Market surveillance programs should be supported by sufficient resources and analytical capabilities. [47]

Enforcement Challenges Involving Commodity Futures Markets

[47] Developing sufficient analytical capabilities may require the development of new analytical tools and approaches. It is for this reason that this report recommends that futures regulators periodically meet to share concerns and approaches to surveillance and enforcement.

Manipulation of market prices is a clear threat to the integrity of the marketplace and to the fundamental purposes of futures markets risk management and price discovery. One of the features of commodity futures markets is the difficulty in proving that manipulation has had or is likely to have a direct effect on price movement. There is a history of regulators working together to create best standards for market manipulation identification and prosecution. In May 2000, the Technical Committee published a report entitled "Investigating and Prosecuting Market Manipulation." The report acknowledged the harmful market effects of manipulation and identified effective means to address manipulative activity. The report recommended that regulators have effective tools to prevent and detect market manipulation, adequate authority to investigate, deter, and prosecute market manipulation, and the ability to cooperate at all stages of a matter. However, the Task Force discussed that a number of issues remain that complicate the successful identification and prosecution of manipulation and other abusive conduct in commodity futures markets. These issues can include:

- inadequate legal framework (i.e., definitions and standards of proof);
- inadequate powers to access information in related underlying markets;
- difficulty of identifying manipulative schemes involving multiple markets and participants;
- lack of ability to investigate non-regulated entities;
- inadequate resources; and
- outdated record-keeping requirements.

The aim for all jurisdictions is to have a legal framework that is able to provide effective enforcement deterrent. As legal systems vary between countries, the following examples intend to address these issues only where appropriate.

RECOMMENDATIONS

- Where appropriate, futures market regulators should review their existing statutory and administrative market abuse authority to determine whether it adequately allows for the prosecution of attempted manipulation. Parties involved in manipulation may not succeed with the scheme to influence the price of a derivatives contract and it may be difficult for regulators to prove perfected manipulation. Futures market regulators should take affirmative steps to request the necessary powers to enforce against attempted manipulation.

- Attempts to manipulate commodity futures markets may often involve conduct in financial and underlying markets. The inability of futures market regulators to access information with regard to certain markets is a material deficiency that should be addressed, where necessary, through legislative action. Futures market regulators should cooperate with any other relevant authorities, domestically and internationally, in order to share supervisory information and to assist in possible investigations of abusive conduct.

- In some jurisdictions, futures market regulators do not have the ability to investigate entities that are not regulated. This can dampen the ability to investigate and enforce manipulative conduct. Futures market regulators should consider requesting authority to investigate all entities for potential manipulative conduct.

- Futures market regulators should ensure that they have sufficient resources for an enforcement program that targets manipulative and other abusive trading conduct, including complicated manipulative schemes involving multiple (i.e. financial and underlying) commodity markets.

- Futures market regulators may wish to consider whether enhancing record keeping requirements, such as telephone recording and extended record retention periods, could be of benefit to the enforcement investigation process.

Enhancing Global Co-Operation

One of the principal challenges noted by the Task Force in its discussions was how members should both unilaterally, and multilaterally, respond to the increasingly globalized nature of commodity markets. Whilst some commodity markets, e.g. local electricity markets, remain largely domestic in nature, partially because of infrastructure restrictions, many are now truly global, e.g. oil and copper markets. Market participants may typically trade through different time zones, from multiple legal entities and at different trading venues for the same underlying as part of an integrated strategy. Global trading strategies have implications for domestic regulation, as multiple futures market regulators with differing responsibilities and powers will typically have responsibility for this "single" activity and face significant challenges to ensure they co-operate appropriately to achieve effective monitoring of the activity and supervision of the entities concerned.

The constant evolution of abusive trading strategies involving multiple markets also potentially challenges surveillance and enforcement, as it complicates both the detection and prosecution of manipulative and other abusive trading in commodity futures markets. Accordingly, the Task

Force encourages co-operation between futures market regulators and other relevant authorities wherever it is appropriate and likely to add value.

The Task Force also noted that the *Tokyo Communiqué* states that futures market regulators should seek to participate in and make use of the *Declaration on Cooperation and Supervision of International Futures Exchanges and Clearing Organizations* (Declaration). Under the *Declaration*, the occurrence of agreed upon triggering events affecting an exchange member's financial resources, positions, price movements or price relationships, or events suggesting manipulation or other abusive conduct, will prompt the sharing of information. [48] A companion *Exchange MOU* similarly prompts the same type of information sharing among commodity exchanges. [49]

Both of these arrangements provide a readily-available structure for prompting the sharing of information that is needed to identify potential market integrity problems as well as the systemic risks associated with a globally active trading firm. Accordingly, futures market regulators and

[48] The *Declaration* (and companion *Exchange Memorandum of Understanding* (Exchange MOU)) were created to address the problem of accessing information about large exposures where exchange member firms and market participants typically trade on multiple exchanges and no one regulator or market authority will have all of the information necessary to evaluate the risks in its markets. The *Declaration*, and *Exchange MOU* were at the core of improvements in international cooperation contemplated at the 1995 Windsor meeting, which was convened following the collapse of Barings Plc.

[49] The Futures Industry Association's Global Task Force on Financial Integrity developed the *Exchange MOU* among markets and clearing organizations. The *Declaration* was developed as a complementary arrangement among regulators both to serve as an independent arrangement for the sharing of information prompted by large exposures or possible manipulation, and as a supplement to the *Exchange MOU* in cases where a governmental regulator was deemed necessary for the sharing of confidential information. Thus, the two arrangements at the exchange and regulator levels are complementary.

exchanges should be encouraged to adhere to and, more importantly, utilize these arrangements, respectively.[50]

Discussions also centered on various practical obstacles to coordination during emergencies. The mundane but vitally critical need for maintaining up-to-date contact lists was noted. In addition, the difficulty of establishing and keeping communication lines open when contact is infrequent was noted as an obstacle to cooperation during an emergency. There is real value in having regular opportunities for meeting and discussing surveillance and enforcement concerns, particularly in an environment that has seen abusive trading schemes involving both financial and underlying markets. Not all regulators have gained experience with these types of schemes and it was observed that it would be useful for futures market regulators to meet regularly to discuss their current concerns about markets as well as to share their surveillance and enforcement approaches.

RECOMMENDATIONS

- The relevant futures market regulators should convene periodically to discuss informally their concerns regarding commodity market activity and their experiences in conducting the surveillance of, analyzing cross-market data for, and investigating and enforcing commodity

[50] The *specific* implementation of any request pursuant to the *Declaration* remains subject to any existing information sharing arrangements between futures market regulators. In this regard, the Task Force emphasizes that the *IOSCO Multilateral MOU* remains the primary vehicle for structuring information sharing among IOSCO members.

cases. Such sharing of contemporary concerns and techniques can strengthen the effectiveness of their surveillance and enforcement capabilities. These meetings may also serve as a basis for organizing commodity markets scenario modeling exercises.

- Futures market regulators should encourage gathering information in a format that can facilitate sharing and analysis of data.

- The Task Force would like IOSCO to consider, as part of its current structural review, how the institutionalization of cooperation among futures market regulators, as recommended above, can fit in with the existing IOSCO framework and how its implementation would be best achieved.

Appendix

First Interim Report on Oil Price Developments and Measures to Mitigate the Impact of Increased Oil Prices, European Commission (1 September 2008) ECFIN/REP 54538-EN

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The Need for Transparency in Commodity and Commodity Derivatives Markets, Piero Cinquegrana, European Capital Markets Institute (ECMI) (2008) http://www.eurocapitalmarkets.org/category/1/2

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