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Commodity derivatives regulation

Taking an objective view

Feature

Commodity prices are headed relentlessly upwards. Much of the blame is being laid at the door of the finance industry and speculative use of commodity derivatives. With politicians calling for a firm stance, regulatory action is certainly needed. But without an objective look at commodity risk, rather than an indictment of the usual financial suspects, the response is bound to fall short.

"Commodity speculation causes starvation" read a placard brandished at a recent anti-globalisation rally. That claim certainly finds echo in popular sentiment. The possibility that the rising price of commodities, especially food, may be linked to the "financialisation" of markets in these products has prompted calls for tighter regulation, especially of commodity derivatives. The demands come as regulators in Europe and America are already seeking to get a firmer grip on derivatives in general. Commodity volatility is a global issue, and the harshest impacts are generally felt in the poorest countries. Unless the underlying problems issues are examined objectively, and unless regulatory initiatives converge, any measures that maybe brought to bear are likely to be underwhelming.

Editorial

"Investing in shares is much too risky!" At least, that is what many French people think. Which is why share ownership in France has been in steady decline since 2006. And the current situation in the markets is unlikely to prompt a change of heart. Yet France has one of the highest savings rates in the world. This shows that the French want to protect themselves not just against intensifying social risks, such as pension shortfalls and long-term care costs, but more generally against the inevitable rollback of the welfare state. So why deprive themselves of an investment that earns one of the highest rates of return over the long term, as research has consistently shown? True, France's disenchantment with equities stems from a serious misapprehension. To ensure the success of privatisation programmes and bring stock market investment to a population that had shunned it since the second world war, the public authorities encouraged the idea that investing in equities was a safe way to make a quick capital gain. Wrong. That is not what equity markets are for. But in the long term, they yield much more than any other form of investment. Making people aware of this fact is crucial, not only so that savers can get the returns they need but also, crucially, because our companies depend on faithful shareholders for their financing. Achieving that awareness will again be one of AMAFI's main areas of focus in the months ahead.

Pierre de Lauzun
Chief Executive, AMAFI

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Feature

Speculation + derivatives = rising prices?

Commodity prices are set to rise in real terms by between 20 and 30 per cent between 2011 and 2020, according to a recent report from the OECD and the FAO. These higher prices are being passed through the food chain, fuelling consumer food price inflation almost everywhere. The situation will be compounded by the increasing use of agricultural output for biofuels. The resulting declines in purchasing power, especially in poor countries, raise the spectre of social unrest. This is one of the factors that prompted President Nicolas Sarkozy of France, which is currently chairing the G20, to call for tighter controls on speculation. But are speculators really the main culprits? And are commodity derivatives really financial weapons of mass destruction?

Basically, speculation is neutral. It simply means buying and selling goods to make a future gain rather than to consume them. The S-word has undeniably gained a negative connotation – it is often equated with investment – but there is evidence that speculation helps make markets more liquid and efficient, for example by lowering bid/ask spreads. Obviously, not all speculation is high-minded but as AMAFI pointed out in a report (see box), many of the harmful effects revolve around informational asymmetry among market participants. Moreover, financial practitioners are not the only speculators. Big trading firms, for example, use derivatives to boost profits on low-margin businesses such as bulk transport and storage.

Despite the criticisms levelled at financialisation, research has consistently failed to establish a direct causal link between investment and commodity price inflation. What's more, there is broad agreement that investors play an integral role in commodities trading – in some cases, they are the only possible counterparties for industrial or commercial firms seeking to hedge exposure. They also provide much-needed liquidity, an issue of growing concern. Jeanine Busserolle, Compliance Officer at Sigma Terme, the specialised hedging arm of InVivo, says "We have noticed a mood of anxiety in the agriculture sector in recent years because the cost of finding liquidity on futures markets has become exorbitant compared with trading and profit margins".

As for the financial instruments themselves, derivatives are hardly a newfangled invention. They have long been used to manage price risk. Two hundred years ago, the Japanese were trading paper coupons against future rice harvests. The Chicago Board of Trade was founded in 1848, and India set up a commodity derivative market in cotton in 1875. Derivatives play an important role in hedging risk and ensuring efficient use of resources in markets such as agriculture and energy. However, with investors turning increasingly to commodities as an asset class, there is no doubt that derivatives and other instruments can be manipulated and that stricter curbs are needed to prevent unlimited and excessive speculation. One of the priorities of France's G20 Presidency – echoed in a bill recently put before the US Congress – is to "find collective solutions in order to reduce excessive commodity price volatility, particularly of agricultural commodity prices, which undermines world growth and threatens food security for populations around the world".

AMAFI Report on Commodity Derivatives Regulation

Since many of its 125 members are involved in commodity derivatives markets, AMAFI wanted to provide realistic, pragmatic and constructive input for the G20. In January it published a report[1] setting out seven priorities and five medium-term targets:

1. Put the Financial Stability Board directly in charge of the high-level coordination function
2. Identify staple commodities for which the new regulatory framework is urgent
3. Ensure minimum levels of transparency and quality for certain physical market data
4. Decide when forward contracts fall within the scope of commodity derivatives markets
5. Give regulators the resources to oversee market participants and trading effectively
6. Use the knowledge acquired to set specific transparency requirements for OTC commodity derivatives markets*
7. Give regulators the resources to intervene through measured use of position limits
8. Develop clearing in commodity derivatives markets*
9. Specify the circumstances in which greater use of organised markets is possible and advisable*
10. Pursue thinking on providing international harmonised guidance to prevent market abuse*
11. Analyse how exchange traded funds and products could influence volatility*
12. Support efforts to revise accounting rules applicable to end users of commodity derivatives markets

* Medium-term target

1 AMAFI / 11-04, January 2011.

Feature

What's being done?

Urged on by policymakers and forums such as the G20, regulators and lawmakers on both sides of the Atlantic have homed in on two major issues related to commodities and their derivatives: better intelligence and better regulation. The US has spearheaded efforts for regulatory overhaul by pursuing the reforms launched by the Dodd-Frank Act. Europe, meanwhile, is mulling new rules as part of the review of two directives, Markets in Financial Instruments (Mifid) and Market Abuse *(see News, Europe),* along with other measures. And international organisations are concentrating on ways to improve the flow of information. Dominique Depras, AMAFI's Director of Market Infrastructure, notes: "Despite setting out with different roadmaps, the various parties seem to be reaching similar conclusions on a number of issues. Interestingly, several of the initiatives echo the priorities set out in our January 2011 report".

If the causal relationship between investment and volatility is unsubstantiated, the link between movements in derivatives markets and the underlying physical markets is obvious and has become a main focus of concern. Reliable intelligence spanning the entire supply chain is vital, and concrete results are being achieved. G20 agriculture ministers announced in June the launch of the Agricultural Market Information System (Amis) to encourage major players on agri-food markets to share data and to promote greater shared understanding of food price movements by collecting information from commodity producers, exporters, importers and traders. To make Amis truly comprehensive, the ministers urged the private sector to take part in the system and called on international organisations such as the FAO and USAID to link their early warning systems to it.

On the regulatory front, the Organization of International Securities Organizations (Iosco) recently published a set of principles aimed at harmonising regulation and supervision of commodity derivatives. The principles cover the design and/or review of commodity derivatives, surveillance of commodity derivative markets, disorderly markets, enforcement and information sharing and enhancing price discovery. Regulators in different jurisdictions are encouraged to cooperate and share information. Importantly, Iosco makes a distinction in terms of disclosure between commercial participants, who are hedging an underlying physical position, and non-commercial participants, who seek a profit by anticipating price movements.
Europe is moving forward carefully. In addition to revisiting Mifid and MAD, the European Commission is introducing a regulation, an instrument that takes direct effect on all member states. The European Market Infrastructure Regulation, Emir, is a response to the commitment made at the Pittsburgh G20 summit to ensure that standardised over-the-counter derivatives are traded on exchanges or electronic platforms and cleared through central counterparties by end 2012. Emir would require all derivatives transactions (OTC and non-OTC) to be reported to a trade repository. In terms of clearing, "financial counterparties" would be subject to more stringent rules than "non-financial counterparties", which benefit from exemptions (though critics say that the definition of the latter category might not cover all the participants' trading activities and could lead to abuse).

The problem of position limits

If the aim of all these measures is the same, the ways to achieve them differ. Proposals by the US Commodities Futures Trading Commission to introduce position limits, effectively capping the amount of derivatives contracts that commodity trades can hold, have proved highly contentious. Critics have argued that the limits would make investors much less willing to act as counterparties to hedges for commodities producers, making markets less liquid and less efficient. Moreover, the measures could drive business away from American and European markets to less stringently regulated markets in the Middle East or Asia. Be that as it may, position limits serve a purpose. Ms Busserolle, for example says her group supports the initiative of the French G20 Presidency. "Wheat isn't just another financial asset, and it's out of the question to let a hedge fund make a squeeze play that could have serious financial consequences but, more importantly, a dramatic human impact."

Hopefully, Europe can learn lessons from the furore and ensure that any similar restrictions included in Emir are carefully measured. For position limits to be effective, regulators must have in-depth knowledge of the markets (including the underlying physical market) as well as real, aggregate exposures for a specific limit. They therefore need to know what positions participants are holding not only on organised markets but also on the physical or OTC markets. Which in turn requires proper cooperation with other regulators, both across geographical areas and in terms of market jurisdiction.

Objectivity

Commodity price inflation is obviously a highly sensitive issue, but also one that can encourage populist responses. Looking objectively for the causes of commodity price volatility, rather than simply lambasting speculators, is vitally important. The FAO/OECD report cites a slower increase in farm output, population growth and heavier reliance on biofuels, among other things. Other obvious sources of upward pressure are steadily rising demand, notably from emerging markets, and interruptions in the supply chain – witness the disastrous fires that wreaked havoc with Russia's wheat crop in 2010.

In a report issued in September 2011 for submission to the G20, the Institute of International Finance argues that the most effective way of tackling excessive commodity price volatility and upward price pressures is to focus directly on underlying supply/demand imbalances. Measures should include steps to alleviate supply constraints, such as removing restrictions on the supply or export of key commodities, or investing in production capacity. Over-zealous or ill-aimed regulation on financial investment could interfere with price signals to suppliers, thereby delaying the supply-side response. In short, the fundamental economic and social utility of commodity derivatives markets should not be called into question. Hopefully, that message will be heard despite ballot-box pressures and the search for quick answers.

Anthony Bulger

News

International

Principles for market infrastructures

AMAFI, FBF and AFTI responded jointly to a consultation on principles for financial market infrastructures, organised before the summer by the Committee on Payment and Settlement Systems (CPSS) of the Bank for International Settlements and the Technical Committee of the International Organization of Securities Commissions (IOSCO).

The three organisations said that on the whole the principles were necessary, relevant and of a high standard *(AMAFI / 11-34)*. Aside from the fact that harmonising rules applicable to infrastructures is vital to the security of financial markets, it is important to clarify the scope of infrastructures' activities. However, some of the CPSS-IOSCO proposals are not wholly satisfactory and ought to be revisited. This is the case, for example, for the definition of the role of central securities depositaries, the regulatory powers given to infrastructures, which are often commercial undertakings, and the way that clearing houses handle defaults.

Emmanuel de Fournoux

Impact of technological advances on regulation

IOSCO's Technical Committee consulted the finance industry on the regulatory issues raised by technological change, notably the recent rapid development of high frequency trading (HFT). Responding, AMAFI stressed that notwithstanding the need for a proper scientific analysis of technological impacts, it backed some of the measures proposed by IOSCO *(AMAFI / 11-32)*, especially prior authorisation of any firm engaged in HFT. In light of the most commonly voiced concerns, it is important that firms which flout rules designed to ensure orderly markets should, where appropriate, lose their authorisation.

AMAFI also contributed to the consultation through the International Council of Securities Associations (ICSA), which also set out its views on these issues in a letter dated 12 August 2011.

Emmanuel de Fournoux

Anti-money laundering

The Financial Action Task Force (FATF) continues to review its standards on anti money laundering and counter terrorism financing (AML/CFT). In late June it organised a consultation aimed at the private sector that addressed some of the key points raised in the first phase of consultation in October 2010. Among the main issues were application of the risk-based approach and the concepts of beneficial owner and Politically Exposed Persons (PEPs) *(see Info AMAFI No 98)*. As before (see ICSA's letter dated 07/01/2011), AMAFI participated through ICSA, which expressed the following:

- Support for the proposed simplified definition of beneficial owner, the identification exemption for companies listed on recognised markets, and the initiative to require governments to ensure closer cooperation between AML/CFT authorities and the authorities in charge of data privacy.
- Fresh emphasis on the need for centralised, simplified access to information about beneficial owners, a point made on several occasions during discussions with the FATF in recent months.
- Renewed request that the risk based approach be applied to identification of beneficial owners and PEPs.

To follow up on the consultation a dialogue with representatives of the private sector, in which ICSA fully intends to take part, is scheduled for next year.

Stéphanie Hubert

International Council of Securities Associations - AGM, 22-24 May 2011

ICSA held its 24th Annual General Meeting in May in London, hosted by the Association for Financial Markets in Europe (AFME).

AMAFI was represented by Chief Executive Pierre de Lauzun and International and European Affairs Director Véronique Donnadieu. Delegates elected Kun Ho Hwang, representing the Korean Financial Investment Association (KOFIA), as ICSA's chairman and welcomed Brazil's Associação Brasileira das Entidades dos Mercados Financeiro e de Capitais (ANBIMA) as a new member. As every year several high-level personalities, including Paul Tucker, Deputy Governor of the Bank of England, and Mark Hoban MP, Financial Secretary to HM Treasury, gave presentations to the meeting.

In parallel, panel discussions with leading figures from the industry and the regulatory community provided an opportunity to debate topical issues.

Véronique Donnadieu

News

Europe

MiFID and MAD – Draft review

The European Commission is due to publish official proposals for revising the Markets in Financial Instruments Directive (MiFID) by early November at the latest. However, a draft version, in the form of a Regulation and a Directive began to circulate in September:

- The Regulation deals with market-related aspects such as data transparency and supply, mandatory trading of derivates on organised exchanges and surveillance of financial instruments and derivates positions.
- The Directive sets out rules on the provision of investment services, conduct of business and the organisation of investment firms and trading venues. It also deals with the powers of competent authorities, penalties, and rules for third countries.

A draft Regulation designed to replace the Market Abuse Directive (MAD) is also doing the rounds. By and large, the three drafts incorporate some of the issues highlighted in the preparatory public consultations. These include:

- establishing a broader pre-trade and post-trade transparency framework covering all financial instruments (including emission allowances), calibrated ex post according to the instruments in question. (The current rules apply only to equities traded on regulated markets.)
- introducing a consolidated tape to improve publication of market data, although this will not lead to the setting up of a single system
- creating a new category of trading venue, the organised trading facility (OTF), which applies to persons that operate trading platforms but are not recognised as a regulated market, multilateral trading facility or systematic internaliser
- strengthening some of the rules applicable to marketing
- extending the market abuse regime to all financial instruments.

These documents should make it possible to begin examining and analysing the forthcoming proposals right away, even though further developments are likely in connection with intermediate projects. Being able to start the analysis as early as possible is very important because of the number of changes proposed and the need to gauge their consequences as accurately as possible. Special attention needs to be paid to the segmentation between the two legal instruments (Directive and Regulation), and to the links between the powers allotted to member states' authorities and those of the new European Securities and Markets Authority. Working groups have started to meet in order to address specific issues.

Véronique Donnadieu

Short selling and sovereign CDS

Negotiations on the European Regulation on short selling and sovereign Credit Default Swaps (CDS), part of the trialogue among European institutions, are advancing with difficulty.

AMAFI once again stressed *(AMAFI / 11-31)* the main points around which the European framework ought to be organised in order to meet the objectives effectively:

- The definition of short selling of financial securities should focus on "reasonable assurance" as to the seller's ability to make timely delivery, thereby avoiding an inevitably complex system of waivers and remaining consistent with US procedures.
- Harmonised buy-in procedures should be a key part of the system, enabling regulators to detect and punish legal entities or individuals that sell securities without prior arrangements to deliver them on time.
- Short positions should be published on an aggregate, anonymous basis since disclosing names would probably encourage herd behaviour, which is counterproductive.
- Europe's regulators must be able to introduce temporary bans when market conditions so require.

AMAFI also reiterated its serious misgivings about rules aimed at introducing a marking system for short sale orders. It believes that the information disclosed to regulators in this way is bound to be piecemeal and that strategies for circumventing the rules would still be possible.

Emmanuel de Fournoux

News

France

Market sounding

AMAFI's Compliance Committee has been making an in-depth analysis of the problems arising from the practice of market sounding, as well as the solutions for addressing them *(see Info AMAFI Nos 97 and 99)*. Given the importance of this issue, particularly for the primary market, AMAFI believes that the rules governing market sounding should be totally overhauled. It is proposing a professional code that will solve some of the problems and make it possible to harmonise or coordinate market participants' practices.

AMAFI is also working on an amendment to Article 216-1 of the AMF General Regulation, which governs market sounding, in order to ensure overall consistency with its code. An initial set of proposals is being discussed with the AMF. Talks will continue during the coming weeks.

Stéphanie Hubert

Taxation

G-20 and Europe to debate the FTT

French President Nicolas Sarkozy and German Chancellor Angela Merkel announced on 17 August that the two countries would file a joint proposal on a financial transaction tax (FTT) with the European authorities. And in the near future the European Commission is due to publish its impact study, probably accompanied by a draft directive, on the feasibility of an FTT. German and French legislators and the European Parliament have already upheld the principle of an FTT, but the UK remains hostile to any tax that is not worldwide. In addition, France has put the issue on the agenda of the G-20 summit on 3 and 4 November, though an international consensus is unlikely in the near term.

AMAFI is naturally monitoring this issue attentively. Echoing its response to the European Commission consultation on financial sector taxation *(AMAFI / 11-21)*, it is stressing the drawbacks of an FTT. These include negative impacts on competition, market liquidity and business financing, as well as the tax's asymmetrical yield and the geographical problems involved in sharing out the proceeds.

In any case, from the conceptual standpoint, an instrument of this sort is conceivable only on a global scale, with the broadest possible base to avoid picking and choosing between regions and products. In tandem with the French Banking Federation, AMAFI has set up a working group to address this issue, which will be a focus of attention in the latter part of this year.

Eric Vacher

Prevention of tax evasion - FATCA

ICSA has set up a working group, which includes AMAFI, to coordinate action aimed at dealing with implementation issues raised by a new US statute, the Foreign Account Tax Compliance Act (FATCA). Representations have been made to domestic and international authorities, pointing out the disproportionate costs and constraints that financial institutions would incur as a result of FATCA. ICSA has written to the US authorities and to Financial Stability Board Chairman Mario Draghi to make that point.

In parallel, a request to put the issue on the agenda of the next G-20 meeting in November has been filed with the French Treasury, in charge of the group's secretariat. The relevant members of ICSA have made similar requests to their own national authorities.

Véronique Donnadieu, Eric Vacher

Amafi Highlights

New Members

Mirabaud France SA

An investment firm specialising in discretionary asset management, order transmission and reception, investment advice and custody account keeping for private clients. The company's officers are Raphael Spahr (CEO) and Cécile Troger-Beltran (Deputy CEO).

State Street Banque SA

A credit institution specialised mainly in custody and administration of financial instruments. The company's officers are Raphael Remond (CEO) and Alain Diaz (Deputy CEO).

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AMAFI documents quoted in this Newsletter and flagged with a reference number are on our website at
www.amafi.fr
Most of them, notably AMAFI's responses to public consultations, are freely available, but some are restricted to members only.

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