FINDING THE RIGHT FRAMEWORK FOR REGULATING COMMODITY MARKETS

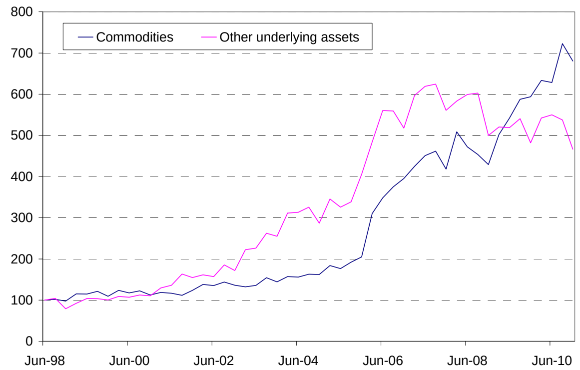
Commodity prices have swung wildly in recent years, with steep rises in the prices of staples compounded by pervasive financialisation of commodity markets. This issue has become a matter of genuine concern for political leaders because of the impact these markets have on economies and citizens' daily lives. France has therefore decided to make commodity regulation a key issue for debate and one of the priorities for its presidency of the G-20.

Building on its financial market expertise, the AMF wished to inform this debate by holding discussions on the regulation of commodity markets. There is no reason to exempt these markets from the general trend towards re-regulation. The same principles implemented for financial markets should also apply to commodities. But special rules also need to be introduced to ensure that these markets continue to serve the needs of their historical users.

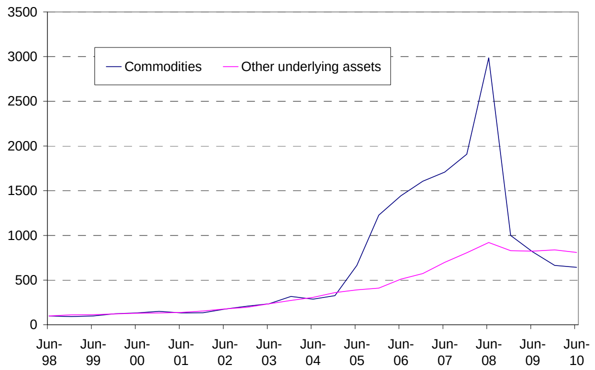
I Background

Commodity markets have existed since the nineteenth century. Long before securities trading platforms started multiplying, commodity producers and users organised themselves to facilitate forward trades and increase certainty about the prices at which they could sell their output or buy their raw materials. They used forward contracts to hedge against future price variations, so that they could plan their investment with greater certainty. The Chicago Board of Trade was set up for this purpose back in 1848. But commodity markets have changed a great deal since then. Today, the participants include traders and financial investors as well as producers and end users of commodities. Trading volumes have increased sharply. The number of contracts traded on organised commodity trading platforms has increased six-fold since 2000, faster than the growth of all derivatives markets combined[1].

Number of derivatives contracts on organised markets by type of underlying asset
(June 1998 = 100)



Notional amounts outstanding of OTC derivatives contracts by type of underlying asset
(June 1998 = 100)



Source: BIS

Last but not least, asset managers and investors now tend to see commodity derivatives as an asset class in their own right, like equities or bonds. These financial investors do not stockpile or hold physical commodities. Instead, they use derivatives markets to expose their portfolios to this new "asset class" without ever actually taking delivery. This trend has spawned many new indices representing different market segments and boosted the supply of investment products aimed at financial investors (see Box).

II Risks related to financial investment in commodities and measures to mitigate them

- **Financial stability risks**

Over-the-counter derivatives, which are often long-term contracts, create strong links between the main financial institutions and complicate the task of removing a failed institution from the financial system since each contract has its own specific clauses on termination and valuation. This means that liquidation procedures take longer and it creates uncertainty for all of the institutions that entered into contracts with the failed institution, making it impossible for them to determine the amounts they are likely to recover. This uncertainty could make all investors wary of the financial system and lead to a string of bankruptcies through the domino effect.

[1] Source: Bank for International Settlements

The AMF supports the following solution for dealing with this risk:
=> establish clearinghouses that are interposed between buyers and sellers, becoming the single central counterparty for each institution. Contracts with these central counterparties are standardised to facilitate settlement and, when an institution fails, the clearinghouse acts as a firebreak.

- **Market abuse risks**

Market abuse generally falls into two categories: insider trading and market manipulation. Manipulation may consist in issuing misleading orders to disguise the participant's intentions or spreading false information.

For many years, the paltry amounts traded on commodity markets meant that regulators, with the notable exception of those in the United States, focused their regulation, detection and enforcement efforts on fighting market abuse on equities markets. As trading volumes on commodity markets have increased, this approach needs to be revisited and greater efforts are needed to supervise these markets.

Commodity markets may also fall prey to other types of market abuse, such as abuse of a dominant position to corner a market. For a market participant, this means gaining control of a market by acquiring a large position that gives it the power to influence prices.

The AMF therefore considers it necessary to:
=> Adapt the concept of market abuse for commodity markets, taking account of the potential insider status of certain commodity producers or users.
For example, electricity markets are highly sensitive to production or consumption incidents since electric power cannot be stored. Accordingly, information about a generation outage in a given plant could have a major impact on the markets. Yet, energy producers cannot immediately stop selling their output when they come across such information, and this puts them in the position of dealing as insiders.
=> Work in each industry to define fundamental output and consumption information that the main producers or consumers will be required to disclose to the market to prevent information asymmetries.
=> Give regulators the power to fix individual position limits on certain markets.
This shows that **the regulatory framework** needs to be adjusted to punish market abuse on commodity markets. This could be done when revising the **Market Abuse Directive**.

In addition to regulatory changes, **transactions on these markets need to be more transparent**. The regulator needs information about trades so that it can detect potentially suspicious patterns. Of course, in addition to covering derivatives trading, such reporting needs to cover physical trading as well, but this will come later, since it is harder to organise. Otherwise, regulators will have only an incomplete view of the market, leaving them unable to understand different parties' strategies.

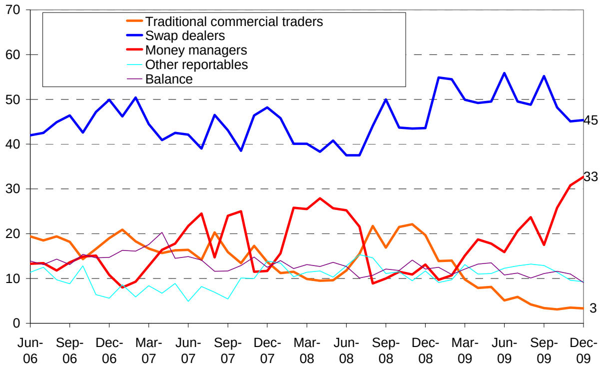
Implementing measures similar to those introduced for financial derivatives, we need to:
=> create central databases to record both derivatives trading and certain physical trades (commercial contracts), with the requirements for the latter to be determined.

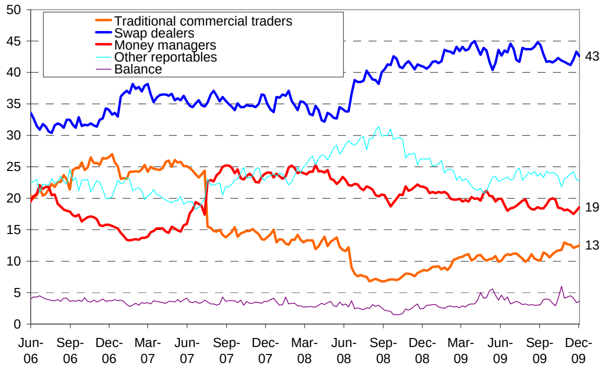
- **Risks of instability and disruption on commodity markets stemming from the excessive presence of financial investors**

The traditional participants' share of trading on commodity markets has shrunk in recent years. For example, on the US copper futures market, it decreased from 20% in June 2006 to 3% in December 2009, and from 20% to 13% on the oil futures market over the same period[2]. Yet, it is critical for these markets to maintain their primary role for hedging against price movements. Financial investors must be present to contribute to liquidity, but without taking over the whole market.

Shares of different categories of traders on the copper futures market *(% of total positions)*	**Shares of different categories of traders on the oil futures market** *(% of total positions)*

[2] Source: CFTC – Commodity Futures Trading Commission, the federal agency responsible for supervising commodity markets in the United States.





Source: CFTC

This financialisation of commodity markets is part of the growing trend to include commodities as an asset class in investors' portfolios. After 2000, the steep fall in equity returns and the bursting of the dot.com bubble, combined with low interest rates resulting from accommodative monetary policies, spurred investors to seek out new sources of yield, just when prices of a number of commodities started to soar. Such investments soon became effective diversification tools, increasing the returns on asset portfolios while decoupling them from returns on other financial assets and offering protection against inflation.

Unfortunately, statistics that distinguish between categories of traders are available only for American markets, which are the only ones that categorise traders in order to track their market shares. **The AMF considers that:**
=> this categorisation of commodity traders, which distinguishes between producers and consumers, on the one hand, and financial investors, on the other hand, should be imported into Europe and deployed internationally if possible, or alternatively, a categorization between trades backing physical flows and speculative trades could be established. Categorisation would help track trading and make it possible to consider position limits for each category of trader to cope with excessive volatility. This would be the only way to control the financialisation of these markets.

Furthermore, the research into the actual impact of financial investment on commodity markets and the growing acceptance of commodities as an alternative "asset class" is not yet conclusive. **The AMF feels that:**
=> further research should be encouraged to improve understanding of how the markets work and to make the relevant adjustments to regulations.
The aim would be to ensure that trading on derivatives markets and spot markets remains coherent.

- **<u>Risks associated with the lack of regulation of certain commodity market participants</u>**

Some commodity market participants, such as the trading subsidiaries of major industrial groups and large dealers are not subject to any regulations. And yet, improper practices by these participants, for example, could create a real threat to the integrity of the market. Therefore, it is important to establish a regulatory system to regulate the activity of such participants and, where appropriate, to punish them.
Furthermore, the marketing practices for commodity derivatives call for closer scrutiny, since the complexity of these products may make them unsuitable for retail investors.

Therefore, the AMF considers that:
=> All participants on commodity markets need to be subject to regulation if they are doing more than merely hedging their production or consumption
=> Supervision of the marketing of commodity derivatives needs to be stepped up, particularly in the case of marketing to retail investors
=> These participants need to be subject to rules on organisation, capital requirements and preventing conflicts of interest.

<u>III Requirements and limitations for establishing a regulatory framework for commodity markets</u>

In addition to identifying the necessary measures for proper regulation of commodity markets, we also need to ensure that such measures are effectively implemented.

Two requirements for implementing such measures should be emphasised. We need to:
=> Create regulatory structures for physical markets, at the European level, if possible. It would be perfectly possible to borrow from the existing regulatory structures for energy markets, such as the Commission de Régulation de l'Energie (CRE) in France or the Agency for the Cooperation of Energy Regulators at the European level. Such structures will be critical for pooling know-how and expertise on market fundamentals for

each commodity, for supervising physical markets and for collaborating with the financial regulator responsible for supervision of the derivatives markets (like the collaboration between the AMF and the CRE on energy markets). Failing that, it will be impossible to develop transparency rules for physical markets that are suited to the way each commodity is traded, which means that the regulatory system will remain flawed.
=> Encourage widespread enforcement of these rules to prevent any risk of regulation shopping. For example, the main contracts traded in France are wheat and corn contracts (and yet the benchmark markets for these commodities are usually more developed foreign markets). This means that establishing a national regulatory framework would not have any impact on the supervision of other commodity markets (oil, metals, other agricultural commodities, etc.) located in London, Chicago, New York, or even in Switzerland or Asia.

The regulatory choices proposed in this paper are aimed at creating the right conditions for efficient and secure commodity markets for the benefit of all stakeholders. However, it should be noted that implementing these choices would not in itself eliminate commodity price volatility. Volatility stems largely from the balance of supply and demand, which changes in line with harvests, discoveries of mineral reserves, global growth and demographic trends.

Of course, market transparency or the introduction of position limits could help limit excess volatility, but such measures will not eliminate price fluctuations. This is only natural, since the proposed regulatory framework is modelled on the regulatory principles for financial markets, which means that it is primarily aimed at ensuring orderly operation, not stable prices.

If regulations for commodity markets were to include a price stabilisation objective, this would call for particularly stringent transparency requirements on physical markets (data on production, stocks, demand trends, etc.), as well as action in other areas beside financial regulation (setting aside emergency stocks or developing coordinated stock management policies). But this takes us beyond the bailiwick of financial regulators, and it is up to others to assess the feasibility and suitability of such measures.

Box: Commodity indices and commodity investment vehicles

An investable commodity index provides a return obtained through a passive investment strategy with the following characteristics:

- only long positions on such indices are possible;
- these indices are based exclusively on commodity futures contracts;
- all futures positions are collateralised;
- the strategy used consists of passive investment in the range of commodities included in the index, without trying to assess or pick one or more specific commodities.

*This type of long-only strategy is mostly chosen by institutional investors with a long investment horizon, such as **pension funds or sovereign wealth funds**. However, these indices are also attracting a growing number of investors seeking gains in the shorter term, such as **hedge funds**, which use much more complex active strategies involving arbitrage and speculation on the volatility of the indices.*

*In addition to providing a simple means of investing in commodities and a benchmark for the performance of such investments, commodity indices also track trends on spot and forward commodity markets. The indices may be global, i.e. made up of a **representative basket** of all commodities, or they may concern a **specific class of commodities** (agricultural products, metals, energy, etc.)*

There are number of commodity indices. The best known and most commonly used are the Reuters/Jefferies Commodity Research Bureau Index (RJ/CRB), the Goldman Sachs Commodity Index (S&P GSCI), and the Dow Jones AIG Commodity Index (DJ AIG CI). The main difference between the indices lies in the weightings attributed to each component commodity. Furthermore, these weightings change over time, as a result of periodic updates to account for changes in such criteria as the level of global production of the commodity or the market value of the relevant futures contracts. In virtually every index, however, oil has the heaviest weighting.

The main investment vehicles using these indices as underlying assets are as follows:

- Exchange Traded Funds (ETFs), which are index funds listed and traded on an exchange;
- Exchange Traded Commodities (ETCs) are also listed on an exchange. The main difference between ETCs and ETFs is a legal one, since an ETC is a zero-coupon bond with no fixed maturity, whereas an ETF is a collective investment scheme;

- Exchange Traded Notes (ETNs) reproduce the risk/return profile of the main commodity investment strategies (long, short, leverage). They are senior and unsubordinated debt securities with an open structure that can reproduce the performance of a single commodity, unlike ETFs, which must comply with diversification rules;
- Notes are exchange-traded transferable securities issued by financial institutions that give the holder the option to buy or sell a commodity or a basket of commodities at a predetermined price (exercise price) up until a given maturity date 1 to 8 years in the future. The legal nature of this instrument is like that of a bond, which means that a note is redeemed when it matures, not at its face value, as in the case of a bond, but at a price that depends on the value of the underlying asset and the inherent characteristics of each type of note. The issuers of these instruments are banks that act as market makers, providing bid-ask spreads for their notes at all times.