Principles for the Regulation and Supervision of Commodity Derivatives Markets

Final Report

TECHNICAL COMMITTEE
OF THE
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

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Chapter 1 Introduction

This Report has been prepared by the Task Force on Commodity Futures Markets (Task Force)[1] of the International Organization of Securities Commissions (IOSCO). The Report responds to the request by the G20[2] at its November 2010 summit in Seoul, Korea for further work on regulation and supervision of commodity derivatives markets.[3]

This work has been emphasized repeatedly by the G20. At its Paris meeting in February 2011, the G20 finance ministers and central bank governors stated that they looked forward to receiving IOSCO's recommendations "on regulation and supervision of commodity derivatives markets notably to strengthen transparency and address market abuse."[4] Continued price pressures on commodities led the G20 Ministers at their meeting in Washington, D.C. in April 2011 to stress "the need for participants on commodity derivatives markets to be subject to appropriate regulation and supervision.[5] The G20 Ministers reiterated their call "for enhanced transparency in both cash and derivatives markets as previously recommended by IOSCO" and "asked IOSCO to finalize, by September, its recommendations on regulation and supervision in this area especially to address market abuses and manipulation, such as through position management powers, including the authority to set ex-ante position limits where appropriate, among other powers of intervention."

A. Prior Task Force Work

These Principles should be read in the context of the ongoing work of the Task Force since it was created by the IOSCO Technical Committee in September 2008 in response to global

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1 The IOSCO Task Force on Commodity Futures Markets is co-chaired by the Commodity Futures Trading Commission (United States) and the Financial Services Authority (United Kingdom) and the following IOSCO members participated in the Task Force: Australian Securities and Investments Commission, Comissão de Valores Mobiliários (Brazil); Alberta Securities Commission (Canada, Alberta); Ontario Securities Commission (Canada, Ontario); Autorité des marchés financiers (Canada, Quebec); China Securities Regulatory Commission (China); Dubai Financial Services Authority (Dubai); Autorité des marchés financiers (France), Bundesanstalt für Finanzdienstleistungsaufsicht (Germany), Securities and Futures Commission (Hong Kong), Forward Markets Commission (India); Commissione Nazionale per le Società e la Borsa (Italy), Financial Services Agency (Japan); Ministry of Agriculture Forestry and Fisheries (Japan); Ministry of Economy, Trade and Industry (Japan); Finanstilsynet (Norway), Monetary Authority of Singapore (Singapore); Capital Market Authority (Saudi Arabia); and Swiss Financial Market Supervisory Authority FINMA (Switzerland).

2 The Group of Twenty (G20) Finance Ministers and Central Bank Governors was established in 1999 to bring together systemically important industrialized and developing economies to discuss key issues in the global economy. The inaugural meeting of the G20 took place in Berlin, on December 15-16, 1999, hosted by German and Canadian finance ministers. http://www.g20.org/about_index.aspx

3 See the *G20 Seoul Summit Leaders' Declaration* (November 11-12, 2010). "Further work on regulation and supervision of commodity derivative markets: We called especially on IOSCO's taskforce on commodity futures markets to report to the FSB for consideration of next steps in April 2011 on its important work", available at http://www.g20.org/Documents2010/11/seoulsummit_declaration.pdf.

4 See *Communiqué Meeting of Finance Ministers and Central Bank Governors*, Paris, 18-19 February 2011, available at http://www.g20.org/Documents2011/02/COMMUNIQUE-G20_MGM%20_18-19_February_2011.pdf

5 See *Communiqué Meeting of Finance Ministers and Central Bank Governors*, Washington, DC, 14-15 April 2011, available at http://www.G20.org/Documents2011/04/G20%20Washington%2014-15%20April%202011%20-%20final%20communique.pdf

concerns, including those voiced by the G-8 Finance Ministers, concerning oil price volatility. Responding to these concerns, IOSCO issued a report in March 2009[6] containing recommendations for improving commodity derivative regulation by securities and futures regulators. The G20 Leaders endorsed these March 2009 recommendations in their September 2009 Pittsburgh Leaders' Statement, and called on the Task Force to collect more oil market data and requested further recommendations on ways to reduce volatility in energy prices. That work stream resulted in reports by the Task Force to the G20 in June and November 2010, respectively, a report to the IOSCO Technical Committee in June 2010, and a report to the Financial Stability Board in April 2011.[7] More recently, G20 Agriculture Ministers committed to share reliable data on agricultural markets in order to increase market information and transparency; they asked for an enhanced collaboration between physical and financial regulators[8] and invited the IOSCO Task Force to make concrete recommendations in their forthcoming report in order to ensure a better functioning of, and more transparent, agricultural financial markets[9].

B. These Principles Build Upon and Expand the Tokyo Communiqué Benchmarks

The Task Force took as its starting point the benchmarks for contract design, market surveillance and information sharing that were set out in the Tokyo Communiqué in 1997.[10]

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6 See *Task Force on Commodity Futures Markets*, Report of the Technical Committee of IOSCO, March 2009 available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD285.pdf.

7 See ibid.

See *OR01/11 Task Force on Commodity Futures Markets Report to the Financial Stability Board*, Report of the Technical Committee of IOSCO 15 April 2011, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD352.pdf;

See *OR08/10 Task Force on Commodity Futures Markets Report to the G-20,* Report of the Technical Committee of IOSCO, 1 November 2010), available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD340.pdf;

See *Task Force on Commodity Futures Markets Report to the G20*, Report of the Technical Committee of IOSCO, 23 June 2010, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD324.pdf; and

See *Task Force on Commodity Futures Markets Survey*, Report of the Technical Committee of IOSCO, 23 June 2010, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD325.pdf.

8 The G20 Agriculture Ministers declaration "*Action Plan for Food price volatility and agriculture*", Paris, 22-23 June 2011 available at http://agriculture.gouv.fr/IMG/pdf/2011-06-23_-_Action_Plan_-_VFinale.pdf: "We decide to launch the Agricultural Market Information System (AMIS) in order to encourage major players on the agri-food markets to share data, to enhance existing information systems, to promote greater shared understanding of food price developments…We emphasize that AMIS will enable financial actors and market regulators to be better informed of the fundamentals of physical markets. A better collaboration between authorities, regulators and bodies responsible for agriculture physical and financial markets will improve regulation and supervision of markets.

9 Ibid: "We welcome the forthcoming work of International Organization of Securities Commissions (IOSCO) based on the set of concrete measures mentioned in its report to ensure a better functioning and more transparent agricultural financial markets (including over-the-counter derivatives), to prevent and to address market abuses, cross-market manipulations and disorderly markets".

10 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 Securities Investment Board, 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 Tokyo Communiqué standards constituted the first set of internationally accepted guidance for contract design and market surveillance and information sharing for physical commodity futures markets. The Tokyo Communiqué focused specifically on physical commodity futures markets because contracts that are based on an underlying tangible commodity, whether settled in cash or by delivery of a physical commodity, may have characteristics different from futures based on underlying financial instruments. This is particularly the case where supply is limited.

The Tokyo Communiqué guidance was intended to serve as a standard against which Market Authorities could voluntarily benchmark their own supervisory programs. IOSCO endorsed generally the Tokyo Communiqué on two occasions. In 1998, the IOSCO Technical Committee reviewed the Tokyo Communiqué for the purpose of determining whether the surveillance and design guidance could be applied to exchange-traded derivatives that are not based on a physical underlying commodity. The Technical Committee endorsed generally the usefulness of the contract design and surveillance guidance contained in the Tokyo Communiqué to all exchange-traded futures, options on futures and options contracts on all types of derivatives.[11] The Technical Committee's 2009 report similarly concluded that the Tokyo Communiqué "continues to provide a comprehensive guidance that can assist Market Authorities in building an effective market integrity program."[12]

C. Evolving Markets and Legislation Prompt the Need for Expanded Principles

Notwithstanding the continued applicability of the Tokyo Communiqué design, market surveillance and information sharing guidance, since 1997 Task Force members have added to these areas of guidance to take into account their domestic supervisory experience and their judgments as to what broad policies are needed to respond to contemporary trends in commodity derivatives markets. These trends are related to the scale, speed and cross-border nature of trading on contemporary commodity derivatives markets, regulators' experience in addressing novel forms of market abuses, the focus by investors on commodities as an asset class and concerns about the impact of those new investor classes on physical commodity prices, and the rapidly evolving regulation of over-the-counter (OTC) derivatives markets:

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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

[11] See *The Application of the Tokyo Communiqué to Exchange-Traded Financial Derivatives Contracts*, Report of the Technical Committee of IOSCO, September 1998, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD85.pdf.

[12] See *Task Force on Commodity Futures Markets*, IOSCO, March 2009, p.14, fn 6.

- ***Electronic trading*** – Most derivatives exchanges are electronic, thus providing direct access to participants that may be located anywhere on the globe. Trading may be guided automatically by algorithms and, depending on the strategy, at high frequency in speeds measured in microseconds. The scale and speed of trading require surveillance authorities to monitor and analyze millions of transactions data daily in order to detect possible abusive trading schemes.[13] Effective surveillance cannot be accomplished without appropriate technology, including sophisticated programs that are capable of detecting patterns within these large volumes of data. Automated surveillance systems that can monitor and analyze order flow as well as intra-day transactions that can take place in a matter of microseconds along with information on end-of-day positions are critical to an effective surveillance program.

- ***Information needs in a global market*** **-** The globally-dispersed nature of markets and market participants requires enhanced forms of sharing of relevant information among Market Authorities. One example that is reflected in these Principles relates to the cross-border trading of contracts that are linked directly through reliance by one contract on the settlement price of another contract traded on another exchange in a different jurisdiction.[14] The scale of global trading and the availability of increasing volumes of data made available electronically require Market Authorities to define with precision the circumstances that justify the sharing of information to support their market surveillance operations and to develop arrangements that implement such necessary surveillance.

- ***Multi-market trading abuses*** **-** Regulators have encountered abusive trading practices that involve trading not only in the futures market but also involve OTC physical commodity derivatives markets and/or the underlying physical commodity. Such practices require an appropriate Market Authority to put into place a robust surveillance and enforcement structure that is designed not only to have the powers and techniques to address abusive conditions affecting *individual* markets, but also to actively detect and respond to abusive trading practices that might involve interaction between *multiple markets* - futures, options on futures, OTC and the underlying physical commodity markets, such as cross-markets manipulation for instance. The Market Authority responsible for detecting such multi-market abusive trading practices must have the ability to access information concerning a market participant's transactions in futures, OTC and physical markets. Such access to information can be achieved by the Market Authority directly or through the assistance of another governmental authority or sectoral regulator, using legal powers. Cooperation among financial and physical market statutory regulators should be fostered.

- ***The impact of futures trading on physical commodity markets*** **-** The

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[13] These evolving markets structures are not, of course, unique to physical commodity derivatives markets. For a discussion of IOSCO's response to these evolving market structures, see the consultation report *CR02/11 Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency*, Report of the Technical Committee of IOSCO, 6 July 2011, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD354.pdf.

[14] For another example, groups may also trade in a consolidated way across global markets using affiliates.

"financialization" of global commodity futures markets (i.e., the increased role of commodities as an asset class for investors),[15] has contributed to growing trading volumes on commodity futures markets. This has raised questions whether such financialization has improved price discovery or whether the increased investment into derivatives markets has contributed to price and volatility surges in the futures markets that affect the underlying commodity markets.[16]

- ***Expanding Regulation of OTC Derivatives Markets*** - The Task Force is responding to major global changes in the regulation of OTC derivatives, as called for by the G20 at its 2009 Pittsburgh meeting in response to the recent financial crisis. The implementation of those G20 commitments, which called for greater standardization, central clearing, exchange or electronic platform trading and reporting of OTC derivatives transactions to trade repositories (G20 Commitments),[17] will substantially bring formerly opaque instruments into greater regulatory oversight. These reforms will require IOSCO members, markets and self-regulatory organizations (SROs)[18] to

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15 See *IMF World Economic Outlook*, Chapter 3 (October 2008) , referred to such financialization by noting that the open interest in crude oil futures traded on the NYMEX had increased 155 percent during 2002-2008, with corresponding figures increasing by 63 percent for gold. Investment in commodity-related assets has increased from below $10 billion in 1997 to about $230 billion in the second quarter of 2008." Available at http://www.imf.org/external/pubs/ft/weo/2008/02/pdf/c3.pdf.

16 Ibid. at pp. 88-92. In this regard, the Task Force's 2009 review of available literature led it to conclude that existing economic research "[did]" not support the proposition that the activity of speculators has systematically driven commodity market cash (physical) or futures prices up or down on a sustained basis. The Task Force recognized, however, that that there was continuing controversy surrounding the interaction between futures market trading and underlying commodity market prices and that such research was subject to data limitations.

As a practical matter, therefore, the Task Force focused its work on recommendations that were intended to improve the transparency and functioning of commodity futures markets. See summary of Task Force work in OR01/11 *Task Force on Commodity Futures Markets - Report to the Financial Stability Board*, 15 April 2011. Fn 7.

17 In September 2009, G20 Leaders agreed in Pittsburgh that: "*All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements. We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse."* See *http://www.G20.org/Documents/pittsburgh_summit_leaders_statement_250909.pdf*.

18 As contemplated by the IOSCO Principles, "an organization should be classified as an SRO (and subject to assessment under Principle 7) if it has been given the power or responsibility to regulate any part of the securities market or industry. See *Objectives and Principles of Securities Regulation*, IOSCO, 10 June 2010, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD323.pdf. As contemplated by the IOSCO Principles, "an organization should be classified as an SRO (and subject to assessment under Principle 7) if it has been given the power or responsibility to regulate any part of the securities market or industry. *See* Methodology for Implementation of the IOSCO Objectives and Principles of Securities Regulation, Principles Relating to Self-Regulation at p.29. Notwithstanding that precise definition, some entities by business custom and informal market reliance may carry out "SRO"-like oversight responsibilities. The design guidance should be referenced by those "informal" SROs as well

See p29 *Methodology for Assessing Implementation of the IOSCO Objectives and Principles Of Securities Regulation*, IOSCO, February 2008, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD266.pdf. Principles Relating to Self-Regulation. Notwithstanding that precise definition, some entities by business custom and informal market reliance

adapt their regulatory and supervisory practices to these new products and trading facilities.

- ***Ensuring an appropriate regulation of market participants*** -. Some major participants in commodities derivative markets (e.g., electricity and natural gas producers and distributors, traders specializing in commodities, etc.) currently legitimately operate outside the purview of financial regulation. This approach has been based on a reviewed assessment of these participants' systemic risk and on the premise that many of them trade only for their own account. It is however critical to keep the scope of financial regulation regularly under review as markets develop to ensure that participants in derivatives markets are appropriately regulated and a further review may be appropriate.

may carry out "SRO"-like oversight responsibilities. The design guidance should be referenced by those "informal" SROs as well.

Chapter 2 Statement of Intent

Task Force members are physical commodity derivatives market regulators whose focus is *inter alia* on ensuring the efficiency and integrity of those derivatives markets.[19] The Principles set out in this Report help to ensure that the physical commodity derivatives markets serve their fundamental price discovery and hedging functions, while operating free from manipulation and abusive trading schemes. These Principles are not intended to address absolute price levels or price volatility in an underlying physical commodity. In this regard, fundamental factors such as fires, floods, droughts, embargos, civil unrest, or export restrictions can have a substantial impact on supply and demand for physical commodities and in turn the prices for a physical commodity. The prices formed in commodity derivatives markets take into consideration, among other things the potential effects of and changes to such fundamental factors.

The Principles set out in this report should be read in light of the following:

A. Authority, Process and Level of Supervision

Unless otherwise specifically noted, the term "Market Authority" used in these Principles means either the governmental regulator, an SRO or the regulated market. This broad definition is used in order to accommodate the varied supervisory practices in use by IOSCO members. Accordingly, these Principles do not prescribe what type of Market Authority or combination of Authorities should be responsible for the regulation and supervision of commodity derivatives markets in a particular jurisdiction.

Rather, the intent of these Principles is to ensure that the relevant Market Authority or Authorities take into account these Principles in exercising their regulatory and supervisory responsibilities.

B. Applicable Commodity Derivatives Contracts

1. Exchange-traded physical commodity derivatives.

These Principles are intended to apply primarily to exchange-traded futures contracts, options on futures contracts and options, for which the underlying reference interest is a physical commodity or physical commodity index or price series and which may settle in cash or by physical delivery. These commodity *derivatives* instruments should be distinguished from transactions in the actual underlying physical market for commodities.

Although, in some cases, these Principles could also be applied to contracts where the underlying interest is a financial instrument[20] or an intangible (e.g., carbon credits) these

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[19] For purposes of this report, the Task Force adopts the following definitions of market integrity and efficiency that appear at p8 of the consultation report CR02/11 *Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency*, 6 July 2011, fn 13: *Market Integrity* is the extent to which a market operates in a manner that is, and is perceived to be, fair and orderly and where effective rules are in place and enforced by regulators so that confidence and participation in their market is fostered. *Market Efficiency* refers to the ability of market participants to transact business easily and at a price that reflects all available market information. Factors considered when determining if a market is efficient include liquidity, price discovery and transparency.

[20] Although IOSCO has determined previously that the Tokyo Communiqué's Design Guidance is

Principles are directed to contracts based on a physical commodity or a non-financial deliverable with finite supply.[21] This Report recognizes that how a particular trading product is characterized will be determined by a jurisdiction's national legislation.

2. OTC physical commodity derivatives.

The Principles for surveillance, disorderly markets, enforcement and information sharing and enhancing price discovery are generally applicable to Market Authorities' oversight of OTC physical commodity derivatives markets. For example, the Principles for surveillance require that a Market Authority be able to access OTC commodity derivatives data under certain circumstances in relation to its oversight of an organized futures market. Although elements of the Principles for contract design are *instructive* to a designer of OTC derivatives, the contract design Principles are not intended to apply as such to OTC commodity derivatives.

This Report has been issued at a time of ongoing developments with respect to OTC derivatives regulation. Although the extent of implementation of the G20 commitments on OTC derivatives varies substantially across jurisdictions, major implementation reforms are underway in the largest developed markets.[22]

At the multilateral level, IOSCO published a report on trading of OTC derivatives,[23] and initiated work-streams with the Committee on Payment and Settlement Systems (CPSS) that focus on the development of OTC derivatives market policies with respect to financial market infrastructures.[24] IOSCO is also working with the CPSS and the OTC Derivatives Regulators' Forum (ODRF) to develop minimum data reporting requirements and standardized formats and the methodology and mechanism for the aggregation of data on a global basis, for market participants reporting to trade repositories (TRs) and for TRs reporting to the public.[25]

These major OTC derivatives national reforms and multilateral work-streams will require IOSCO members to construct regulatory and supervisory policies to address the particular

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relevant to derivatives that reference a financial instrument, it cautioned that Market Authorities may need to place different emphasis on specific issues (such as delivery characteristics or cash settlement terms). See *The Application of the Tokyo Communiqué to Exchange-Traded Financial Derivatives Contracts*, September 1998, fn 13. Accordingly, this Guidance has not considered any derivatives that are based upon a financial instrument.

21 See *Tokyo Communiqué on the supervision of commodity futures markets*, 1997, available at http://www.meti.go.jp/policy/commerce/intl/tkyc.pdf, at Introduction (¶1 and fn. 2) and Design Guidance Annex "A" (fn. 2.)

22 For a discussion of G20 OTC derivatives markets reform implementation, see *OTC Derivatives Market Reforms: Progress report on Implementation*, Financial Stability Board, 15 April, 2011, available at http://www.financialstabilityboard.org/publications/r_110415a.pdf.

23 See FR03/11 *Report on Trading of OTC Derivatives*, Report of the Technical Committee of IOSCO, 18 February 2011, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD345.pdf.

24 See *Principles for Financial Market Infrastructures*, Consultation Report of the Committee on Payment and Settlement Systems and the Technical Committee of IOSCO, 10 March 2011, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD350.pdf.

25 See *Report on OTC Derivatives Data Reporting and Aggregation Requirements*, Consultation Report of the Committee on Payment and Settlement Systems and the Technical Committee of IOSCO, 24 August 2011, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD356.pdf.

state of development of OTC derivatives infrastructure within their jurisdiction.

Accordingly, the extent to which the Principles can be specifically applied to OTC physical commodity derivatives and OTC physical commodity derivatives that will be executed on an electronic trading or execution facility in a particular IOSCO member's jurisdiction will depend upon the legislation and OTC derivatives infrastructure in a particular IOSCO member's jurisdiction. [26]

C. Other Structural Measures

This Report should be read in conjunction with other Principles and guidance developed by IOSCO, such as the IOSCO Objectives and Principles of Securities Regulation (IOSCO Principles), in particular the Principles on Secondary Markets and the related Assessment Methodology, which set out Principles and guidance of general application to all markets.[27] The G20 Seoul Summit leaders also called on IOSCO to develop and report to the Financial Stability Board "recommendations to promote markets' integrity and efficiency to mitigate the risks posed to the financial system by the latest technological developments." IOSCO has initiated a separate work-stream undertaken by the Technical Committee's Standing Committee 2 on secondary markets (SC2), to respond to that G20 commitment.[28] When finalized, the recommendations contained in that separate report should be read in conjunction with this Task Force Report on physical commodity derivatives markets.

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[26] Any determination to assess a jurisdiction's compliance with these Principles must take into account that jurisdictions are in varying stages of development with respect to OTC derivatives legislation. Assessment officials must recognize that even where such legislation is adopted there must be careful development of implementing regulations and policies to integrate OTC derivatives into a Market Authority's overall regulatory and supervisory approach. Assessment must also take into account the functional differences between derivatives and equity securities, as well as the particular statutory treatment accorded those instruments in a particular jurisdiction. They should also take into account the size, structure and complexity of the relevant market.

[27] See also IOSCO reports cited at fn 69.

[28] See CR02/11 *Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency*, IOSCO, 6 July 2011, fn 13.

Chapter 3 Principles for the Design and/or Review of Physical Commodity Derivatives Contracts

A. Introduction

In contrast to decentralized markets, organized commodity derivatives markets provide enhanced price transparency and liquidity, and eliminate credit risk between counterparties when trades are cleared by a central counter-party (CCP). These attributes of organized exchanges, such as futures exchanges, are feasible because the contracts are standardized. Some of the principal economic purposes of organized trading of commodity derivatives such as futures contracts are to manage price risk and facilitate the discovery of possible future commodity prices. To be an effective economic tool for hedging and price discovery, commodity futures contracts must accurately reflect the characteristics and operation of the referenced underlying physical commodity market, and not contain factors which may inhibit or bias the delivery process

Where contract terms are not consistent with commercial practices or the delivery process is biased in favor of either participant, the contract may not be commercially successful or it may be susceptible to market abuses or manipulation and contribute to price distortion and disorderly markets. A non-robust contract design may lead to a lack of price convergence between a commodity futures contracts and the referenced underlying physical commodity at the expiration of the contract. As a result, the contract is of less use as a hedging tool and could even multiply risk by doubling positions, rather than offsetting them.

A key objective of the contract design Principles is to eliminate, to the extent possible, the susceptibility of the futures contract to price manipulation or distortion. However, even well-designed contracts can be subject to manipulation or price distortion, which may result from schemes involving different types of commodity markets, both derivatives markets (e.g., futures and OTC derivatives) and physical commodity markets. Therefore, although contract design principles are a critical element of derivatives market integrity, they should be viewed as a complement to and not a substitute for appropriate market surveillance and enforcement programs.

The following contract design Principles have been drafted to apply principally to futures contracts, options on futures contracts, and options, for which the underlying reference interest is a physical commodity or physical commodity index or price series and which settle in cash or by physical delivery. For convenience, the text refers primarily to futures contracts.

Although elements of the contract design Principles may be instructive to the designers of bespoke OTC commodity derivatives or to *standardized* OTC derivatives that will be executed on an electronic execution facility, they are not intended to apply as *Principles* to such contracts. A bespoke OTC derivative and a *standardized* OTC derivative, required under the Market Authority's relevant legislation to be executed on an electronic trading facility, would not necessarily incorporate all of the characteristics of a futures contract and may not be designed to trade actively like futures contracts.

Market Authorities are likely to find elements of the contract design *Principles* to be more relevant to any such contracts that are designed to have standardized, futures-like characteristics, and, if executed on an electronic trading facility, begin to trade actively like a

futures contract, serve a price discovery function and/or are linked to, or otherwise have an effect on, an exchange-traded futures contract.

B. Contract Design Principles[29]

These Contract Design Principles are intended to apply throughout the life of a commodity derivatives contract, from its initial listing onwards.

> **Principle: Accountability** – *Market Authorities should establish a clear framework as to design and review criteria or procedures for commodity derivatives contracts. Market Authorities should be accountable for compliance with statutory and/or self-regulatory standards on a continuing basis and should retain powers to address the provisions of existing contracts which produce manipulative or disorderly conditions. At a minimum a statutory Market Authority should have legal powers to address and where necessary to vary contract provisions which produce, or are deemed likely to produce, manipulative or disorderly conditions.*

Irrespective of which entity designs and/or reviews a commodity derivatives contract, the framework governing such process should be clear, and the Market Authority should be accountable on a continuing basis to comply with relevant standards set by the statutory or self regulatory Market Authority.

At a minimum, a Market Authority that exercises statutory powers should have the ability to address contract provisions which produce, or are deemed likely to produce, manipulative or disorderly conditions, by intervention appropriate to the circumstances,[30] including the exercise of authority to vary contract provisions or suspend or even to terminate trading in a contract based on market integrity concerns.[31] These powers need to be clearly delineated by the Market Authority so that market participants are able to understand the circumstances under which a contract term or condition could be modified.

Accountability implies more than the mere retention of necessary powers, by entailing a solid framework for the appropriate use of those powers. For example, the commercial practices in a physical commodity market are dynamic. Changes in those cash market practices that are no longer described by the commodity derivatives contract's terms and conditions could materially affect the utility of the contract as a hedging instrument and make it more susceptible to manipulation or disorderly conditions.

It follows that the relevant Market Authority that is responsible for the design of a commodity derivatives contract should have staff who continue to be aware of commercial practices in the physical commodity market that underlies a derivatives contract and who will

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29 Throughout this report, all of the *Principles* are denoted by italics, and followed immediately by text that is intended to highlight key issues that are related to the principle in question. The *Discussion* sections that generally follow provide further background and guidance to Market Authorities.

30 Actions affecting open positions see *Tokyo Communiqué* Annex B Guidance on Components of Market Surveillance and Information Sharing, fn 21, should be designed to minimize any impact on market operations.

31 The Market Authority will make this determination based on its assessment of need. For example, a continuing divergence between the futures settlement price and the underlying physical market price could, upon analysis, cause a Market Authority to vary the terms of the future contract.

recommend appropriate action if those practices vary from the initial terms and conditions of the derivatives contract. The relevant Market Authority should have clear guidelines concerning the circumstances that will trigger a reevaluation of a commodity derivatives contract's terms and conditions. In this regard, concerns expressed by commercial participants in the commodity derivatives contract should prompt a reevaluation of the contract's terms and conditions.

> **Principle: Economic Utility -** *Contracts should meet the risk management needs of potential users and promote price discovery of the underlying commodity.*
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> *The design and/or review of commodity derivatives contracts should include a determination that the contract can meet the risk management needs of potential users of the contract and/or promote price discovery of the underlying commodity. The determination of economic utility may be supported by surveys of potential contract users or may be implied - for example, from an analysis of the physical market.*
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> *The regulator should, as a minimum requirement, be informed of the type of products to be traded on an exchange or trading system and should review and/or approve the rules governing the trading of the product.*

The more accurately a commodity derivatives contract reflects the operation of the relevant underlying physical market, the greater the likelihood of its economic utility as a tool for hedging and price discovery. Consistent with the IOSCO Principles on Secondary Markets, the exchange's regulator should, as a minimum requirement, be informed of the types of products to be traded on the exchange or trading system, and should review or approve the rules governing the trading of the products. In doing so, the exchange and/or the regulator should consider contract design Principles, where applicable.

Discussion

No proven set of terms and conditions has been established that will ensure that a commodity derivatives contract on an underlying physical commodity will be commercially successful. A review of successful and properly functioning commodity futures contracts indicates certain physical market conditions that, if present, enhance the possibility that a particular physical market may support a properly functioning commodity derivative contract. These physical market conditions are as follows.

- *An active physical market should exist prior to the development of commodity derivative contracts*. Active physical commodity markets provide commodity derivatives markets with a large pool of potential commercial participants and transparent, reliable pricing.

- *Production and consumption of the commodity should be widely distributed among a large number of producers, merchants, and consumers*. The wide dispersal of production and consumption of the underlying commodity reduces the ability of any individual, or group acting in concert, to control the supply or demand for the commodity. For example, a large vertically integrated industry, which owns facilities for the mining of or drilling for a needed physical commodity, would have less need for a commodity contract.

- *An adequate supply of the commodity should be economically available (i.e., at an economically viable price) in the physical market to meet commodity market delivery needs at contract expiration*. Limitations on economically available supply of the commodity or commodities permitted to be delivered under the contract may result in market congestion, squeezes, corners or other disruptions if holders of short commodity contract positions cannot obtain the underlying commodity to satisfy their delivery obligations.

- *Price risk must be associated with the commodity in order to attract hedgers and speculators to a commodity market.* Commercial market participants (e.g., producers, merchants and consumers/users of a commodity) would have limited incentive to hedge against potential physical market price changes if such commodity prices were stable or could be reliably predicted. Commercial market participants are more likely to use commodity contracts to hedge against physical market price movements when such price movements can be material and unpredictable. The extent to which the supply, demand or price of a physical market commodity is stabilized by government or cartel regulation would be a significant factor in determining whether a commodity derivatives market is needed.

It is difficult to establish trading interest in a new commodity derivatives contract when producers, merchants, and consumers of a commodity already have access to alternative liquid hedging instruments traded elsewhere (e.g., off-exchange). Hedgers and speculators may prefer an established hedging instrument because the existing liquidity, and the consequential smaller bid/ask spread, among other things, result in lower costs to transact as compared to a newly-established market. However, a new exchange-traded commodity contract whose standardized design conforms to physical market practices could attract trading volume from established hedging instruments by offering enhanced price transparency and minimizing counterparty risk.

In order to facilitate commercial use of the market for hedging or pricing, consideration should be given to providing for alternate settlement mechanisms, such as properly structured and monitored exchange-for-physical transactions that permit settlement to be effected or delivery to be made with a different grade or quality or at a different location. Any such alternatives should be specified.

> **Principle: Correlation with Physical Market -** *Contract terms and conditions generally should, to the extent possible, reflect the operation of (i.e., the trading in) the underlying physical market and avoid impediments to delivery.*

The purpose of designing a commodity derivatives contract to reflect the operation of the underlying physical commodity market is to avoid or minimize the possibility of manipulation or price distortion in the commodity derivatives contract.

For example, the price of a commodity futures contract at expiration should reflect the value of the underlying physical commodity as specified in the terms of the commodity futures contract, plus or minus the costs associated with making or taking delivery, as well as any other clearly defined and known divergence between the futures contract's specifications and the contract's delivery *basket*. For physical delivery contracts, the possibility of delivery is the market force that usually causes convergence of physical and futures markets at expiration. However, there are instances where futures markets are susceptible to non-

convergence of cash and commodity prices, price distortion or manipulation when there are impediments to making or taking delivery.

A high correlation between physical market prices and commodity futures market prices may be achieved by designing the futures contract with terms and conditions which conform to the prevailing physical market commercial practices of the commodity underlying the futures contract. A well-designed contract therefore provides surveillance staff with visible physical market metrics e.g., commercial practices in the physical market) that can be the subject of surveillance monitoring, as needed.

Accordingly, exchange-traded commodity derivatives contracts such as futures contracts should, to the extent possible, be designed to conform to prevailing physical market commercial practices, including commodity grade and quality specifications, to avoid impediments to delivery and reduce the likelihood of non-convergence of physical and commodity derivatives prices, manipulation or a disorderly market. The terms and conditions should result in a deliverable supply that reasonably can be expected to be available to short traders and saleable by long traders at its market value in normal cash marketing channels. In this regard, delivery locations should be selected to ensure adequate and sufficient supply of the deliverable commodity.

Discussion

Characteristics of the underlying physical market

Designing a commodity contract to conform to the underlying physical market of the commodity requires a detailed understanding of the characteristics and operational features of the relevant physical market. Particular attention should be given to the cash pricing and delivery systems as well as historical patterns of production, consumption, and supply of the underlying commodity, including whether the commodity is seasonal in nature or produced or consumed in limited geographical regions. Smaller physical markets with limited deliverable supplies may require additional surveillance by Market Authorities.

Market Authorities should consider, without limitation, the following physical market characteristics in designing and/or reviewing commodity contracts, including differences within a commodity market with regard to the commodity in question:[32]

1. Size and structure of the physical market;

2. Commodity characteristics (e.g., grade, quality, weight, class, growth, origin, source etc.);

3. Historical patterns of production, consumption and supply, including seasonality, growth, market concentration in the production chain, domestic or international export focus and logistics;

[32] A Market Authority may choose to impose more rigorous standards where physical market practices are relatively informal. Exchanges also may offer their own dispute resolution procedures that differ from physical market conventions. Also, additional or different considerations may apply to OTC contracts that provide more variation, and would be considered "non-standardized"; this guidance is not intended to restrict such innovations.

4. Extent of distribution (dispersal) of production and consumption of the physical commodity among producers, merchants and consumers;

5. Accepted market practice at the physical commodity market in question, including loading tolerances and delivery of alternative supply under the contract terms;

6. Adequacy, nature and availability of supply of the physical commodity, including an estimate of the deliverable supplies for the delivery month specified in the commodity contract;[33]

7. Movement or flow of physical commodity;

8. Liquidity of the physical market;

9. The cash pricing system including transparency, availability, reliability and frequency of cash pricing;

10. Price volatility; and

11. The existence of price controls, embargoes, export restrictions or other regulation or controls affecting the price or supply of the physical market commodity.

Delivery specification issues for physical delivery contracts

If commodity derivatives contracts are designed to require the physical delivery of the underlying commodity in satisfaction of positions remaining open at contract expiration, the following contract delivery specification issues should be considered:

- *Quality or deliverable grade.* A commodity derivatives contract should set forth a complete specification of commodity characteristics for par delivery, including those relating to grade, class, and weight. The quality or grade of a commodity that will satisfy the contract's delivery obligation should conform to the prevailing practices in the underlying physical market and be fully specified as part of the contract's terms and conditions. Contracts that call for delivery of a specific quality of commodity may provide commercial participants with a clearer, more efficient hedging and price-basing instrument than a contract that permits delivery of a broad range of commodity grades or classes. However, contracts that permit delivery of only a specific grade of commodity may be susceptible to manipulation if that grade of the commodity is in short supply or controlled by a limited number of sellers. If deliverable supplies of a commodity are expanded beyond par grades to reduce the likelihood of manipulation, Market Authorities should assess the premiums or discounts assigned the non-par grades to ensure that they are set at levels that are consistent with the physical market.

- *Size of delivery unit.* Any deviation from the physical market delivery size (e.g. rail

[33] This data is needed to support an analysis of the contract's settlement reliability.

car, barrel, bushel etc.) or composition should be closely examined to ensure that it does not constitute a barrier to delivery or otherwise impedes the physical delivery of the commodity.

- *Delivery instruments.* The contract should specify acceptable delivery instruments including warehouse receipts, bills of lading, shipping certificates, demand certificates, or collateralized depository receipts. The contract also should specify whether such instruments are negotiable or assignable and under what conditions.

- *The Delivery Process.* The delivery process, including timing, location, manner and form of delivery should reflect physical market practices to permit monitoring and to reduce the likelihood of disruption.

- *Delivery points.* Issues associated with identifying acceptable delivery locations include: (a) the level of deliverable supplies normally available, including the seasonal distribution of such supplies, (b) the nature of the physical market at the delivery point (e.g., auction market, buying station or export terminal), (c) the number of major buyers and sellers, and (d) normal commercial practices in establishing cash commodity values. Consistent with the grade differentials discussed above, commodity contracts that permit delivery in more than one location should set delivery premiums or discounts consistent with those observed in the physical market. The adequacy of transportation links to and from the delivery point should be considered.

- *Type of delivery facility.* Delivery facilities can include warehouses or elevators for agricultural commodities, bank or vault depositories for precious metals. Issues associated with the selection of delivery facilities include: (a) the number and total capacity of facilities meeting contract requirements; (b) the proportion of such capacity expected to be available for short traders who may wish to make delivery against commodity contracts and seasonal changes in such proportions; (c) the extent to which ownership and control of such facilities is dispersed or concentrated; and (d) the ability of the Market Authority to access necessary information from such facility.

- *Inspection and certification procedures.* The contract should contain terms detailing any inspection or certification procedures for verifying that the delivered commodity meets the quality or grade standards of the contract. These terms and conditions should conform to physical market practices. If the commodity is perishable, the contract should state if there is any limit on the duration of the inspection certificate and the existence of any discounts applied to deliveries of a given age.

- *Payment for transportation or storage.* The commodity contract should contain terms and conditions detailing the parties' responsibilities regarding costs associated with transporting the commodity to and from the designated delivery point. The contract also should specify how and when title to the commodity transfers from the short to long position holder as well as the responsibilities of the parties with respect to any storage costs.

- *Contract Delivery Months.* The delivery months of the commodity contract should take into account cyclical production and demand. Delivery months should be listed

when sufficient deliverable supplies are expected to exist in the physical market. Seasonality of a commodity also may affect the availability of warehouse space and transportation facilities.

- *Legal Enforceability.* If the trading, clearing and/or settlement by delivery of a commodity contract takes place across different legal jurisdictions, a disparity between governing laws may cause interpretation differences of the contract terms; for instance, through a technical default on delivery obligations, delivery disputes, interpretation of the contract or insolvency proceedings resolution. The legal risk of unenforceability of a contract, when subject to multiple legal systems, would need to be assessed before the contract's launch. The Market Authority should identify and seek to mitigate this risk which is particularly acute for laws governing cargoes and their storage, in the application of exchange and clearing house rules.

- *Default Provisions and Force Majeure.* The commodity derivatives contract should set forth the rights and obligations of the parties in the event of default by the buyer or seller and whether and the manner in which the clearinghouse or exchange guarantees settlement of the transaction.[34] Contractual monetary consequences imposed upon or collateral received from defaulting parties should be sufficient to address the replacement risk and performance of the contracts. The contract also should specify the terms, if any, under which a party may be excused from its performance obligations due to events beyond its control.[35] Local commercial law may influence how the contract is designed and contract terms should specify the governing law.

In all cases, contract terms that deviate from physical market practice (which may at times be necessary) should be explained and justified in light of their likely impact on orderly trading, their effect on deliverable supplies and price convergence.

Principle: Promotion of Price Convergence through Settlement Reliability - *Settlement and delivery procedures should reflect the underlying physical market and promote reliable pricing relationships and price convergence and should be regularly evaluated to ensure that they meet this standard. Settlement and delivery terms should be specified and made available to market participants.*

This Principle focuses on factors that might make the contract susceptible to manipulation or price distortion. These factors generally relate to the size and liquidity of the underlying physical market and to the reliability of the price series or index upon which settlement is based.

Settlement is the act of fulfilling the performance requirements of the commodity derivatives contract. Settlement may be effected either by physical delivery or cash payments. Whether settlement is by cash or physical delivery, the relevant Market Authority responsible for contract design should be able to demonstrate that the price series or index that is referenced as a settlement price in a physical commodity derivatives contract is a reliable indicator of

[34] This would also be determined by local law or the law adopted in the contract if different, or both, as well as the exchange or clearinghouse rules.

[35] Exchanges or their clearing house may choose to incorporate this in their business rules rather than the contract specifications.

transactions in the underlying physical market, publicly available and timely. Such reliability is essential to ensure that the contract serves a reliable and acceptable hedging and price discovery function.[36]

Discussion

Cash settlement

Cash settlement means that at contract expiration, the contract is settled by cash payment in place of physical delivery of the underlying commodity. A Market Authority should evaluate the susceptibility of a cash-settled contract to manipulation or price distortion.

In this regard, a Market Authority should consider the size and liquidity of the underlying physical market. Situations susceptible to manipulation include those in which the volume of cash market transactions and/or the number of participants determining the cash-settlement prices are relatively low. Under such circumstances there could be an incentive to manipulate or artificially influence the data from which the cash-settled price is derived or to exert undue influence on the cash-settlement price's computation in order to profit on a derivatives contract position in that commodity.[37]

Market Authorities should also focus on the reliability of the price series or index referenced in the commodity derivatives contract. A key concern is that the data from which the cash-settlement price is derived will not be susceptible to manipulation or otherwise artificially influenced or distorted.

A commodity derivatives contract will not be readily susceptible to manipulation or distortion if the cash price series or index used for settlement is reliable (*i.e.,* the settlement price should accurately reflect prices in the underlying physical commodity market). Contract design considerations addressing reliability should include an analysis of the reliability of the physical commodity reference price on which pricing of the contract is based, public availability and timeliness of pricing information, commercial acceptability and public availability of the price series or index that is used to calculate the cash settlement price, liquidity of the physical market and the potential for price manipulation or distortion of the price used for cash settlement.

Design considerations should also ensure that the size of the sample used to determine the price series or index is sufficiently broad to be representative of the underlying physical market. The price series (or index) should be based on a sufficiently large record or survey of transactions such that it cannot be readily manipulated to advantage a position in the cash-settled contract. Moreover, the price series should be based on sufficient physical market activity – geographically and seasonally – covering a broad cross-section of market participants.

A Market Authority's ability to review the procedures that are utilized to develop a commodity contract's settlement price will vary depending on whether the price series or index is constructed by a regulated market or a third-party provider. A regulated market is by

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[36] See OR08/11 *Task Force on Commodity Futures Markets Report to the G20*, IOSCO, November 2010, fn 7.

[37] See cases cited in the Enforcement Section of this Report.

definition subject to direct oversight by a governmental regulator or SRO, who generally will have power to review the contract if necessary.

In contrast, Market Authorities generally do not have jurisdiction over third-party price reporting agencies. In this regard, information provided by third-party price reporting agencies (PRAs) plays a critical role with regard to the design of commodity derivatives contracts and as a basis for the floating price component for settlement of OTC commodity derivatives contracts. A commodity derivatives contract that references an opaque or unrepresentative price series could be more susceptible to manipulation.

Accordingly, Market Authorities responsible for contract design or the review of contracts that reference a price series or index should be able to demonstrate that the relevant price series or index is reliable, acceptable, publicly available and timely. In addition to disclosure of the methodology used to construct an index, Market Authorities should be able to access the actual reported transactions used to form the price series or index, to be able to assess whether the prices reliably reflect actual physical commodity market prices.

In the case of a third-party price series or index provider, the Market Authority should be satisfied that the third party provides safeguards against susceptibility to manipulation. Where the market itself generates a cash market price series, it should be able to demonstrate the specifications of the calculation procedure and the robustness of safeguards in the cash settlement process to protect against susceptibility to manipulation.

There should be clear and timely procedures for general publication of price series or index values.

Physical Delivery –the importance of physical delivery terms for price convergence

For derivative contracts calling for delivery of the underlying product, delivery is the critical mechanism that drives price convergence. For example, as a futures contract approaches expiration, differences between the futures price and the cash price (which generally reflect the sum of the costs and benefits of storing, handling, transporting and lending income and convenience yield of the cash commodity (i.e., the carrying costs) should be reduced. There always will be some *frictional* differences due to differences between the terms and conditions of the commodity derivatives contract and the physical commodity actually delivered, such as for example actual storage and transportation costs and recognized delivery grade variations.

Effective convergence requires not only that the terms and conditions of the contract generally reflect the operation of the underlying physical market (see preceding condition), but also that those terms and conditions will result in an adequate deliverable supply that reasonably can be expected to be available to both long and short traders at its market value in normal physical marketing channels. The totality of these design considerations help ensure that the contract will not be susceptible to manipulation or distortion.

Key considerations that promote effective price convergence for a physical delivery commodity futures contract should include an analysis of deliverable supplies and locations, quality or grade of the deliverable commodity, inspection and certification procedures, size of the delivery unit, adequacy (including accessibility and financial condition) of delivery points and facilities, and the delivery process (timing, storage, transportation). A straightforward

and well designed delivery process promotes arbitrage between the physical and futures market that is necessary for convergence to occur, provided the terms and conditions accurately reflect the physical market, those terms and conditions as well as market practices are clear to market participants, and there is sufficient liquidity in the commodity derivatives contract.

The estimate of deliverable supply should reflect the quantity of the referenced commodity product that is or will be in store at the delivery point(s) specified in the commodity contract or that economically can be moved into or through such points within a short period of time after a request for delivery and which is available for sale on a spot basis within the marketing channels that normally contribute to the delivery points.

In particular, delivery terms should be scrutinized closely for possible impediments to delivery or incentives not to deliver. Such impediments may be related to the inherent nature of the commodity as traded in the physical market (such as the size of deliverable supply or seasonality, supply and demand of the commodity, the types of participants dealing in the physical commodity and their specific trading practices) or to the mechanics of the delivery process (e.g., transportation requirements, costs of inspection).[38]

For example, with respect to physical-delivery commodity contracts that use a shipping certificate or similar delivery instrument, the consideration of deliverable supply should reflect the fact that the underlying commodity may not have to be moved into or through the delivery point(s) prior to delivery of the shipping certificate in the futures market.[39] Similarly, if a change occurs in the production areas, marketing patterns, or export locations for a commodity, the delivery locations specified by the contract could eventually deviate from customary merchandising arrangements and no longer reflect commercial realities.

> **Principle: Responsiveness** - *The views of potential contract users should be taken into account in designing commodity contracts.*

The views of potential contract users, particularly commercial users, should be taken into account in the design of commodity derivatives contracts. For example, potential contract users may have special needs related to the size of the contract, the commodity grade or the conditions of delivery which, if addressed, could enhance the economic utility and commercial viability of a contract.

Ideally, markets themselves will have a commercial interest in the economic utility and viability of a contract. The regulatory interest is related to the commercial interest in that each seeks to ensure that the contract will not be readily susceptible to manipulation so as to ensure a well-functioning market.

> **Principle: Transparency** - *Information concerning a physical commodity derivatives contract's terms and conditions, as well as other relevant information concerning*

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38 Cases of *force majeure* affecting delivery should be addressed by surveillance programs see fn 30.

39 For an illustration of the complex manner in which delivery terms may affect price convergence (and the differing academic analyses regarding the convergence issue) see *Report and Recommendations of the Subcommittee on Convergence in Agricultural Commodity Markets to the Agricultural Advisory Committee of the Commodity Futures Trading Commission on Convergence in Wheat with Implications for Other Commodity Markets*, Commodity Futures Trading Commission, 2009, available http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/reportofthesubcommitteeonconve.pdf.

delivery and pricing, should be readily available to Market Authorities with respect to all derivatives transactions within its jurisdiction and to market participants in organized derivatives markets.

Without limiting the factors that a Market Authority includes in those terms and conditions, market rules should specify, for example:

i. Minimum price fluctuations (price ticks);

ii. Maximum price fluctuations (daily price limits), if any;

iii. Last trading day;

iv. Settlement and delivery procedures;

v. Trading months;

vi. Position limits, if any;

vii. Reportable levels; and

viii. Trading hours.

Information concerning the operation of the physical commodity derivatives market, delivery requirements (acceptable delivery instruments, delivery procedures, delivery points, etc.), pricing in the physical and futures markets and the terms and conditions of the commodity contract and related rules and procedures of the market (e.g., price limits and other aspects of the contract such as position limits) should be readily available to Market Authorities and market participants.

Where commodity derivatives markets operate, or their incentive arrangements promote, trading in a contract, the existence of such programs should also be published to market participants and remain subject to regulatory oversight.[40] The pertinent areas should be contained within a clear, concise and publicly available contract specification.

[40] Some Market Authorities require the existence of an incentive scheme and its basic benefits to be made public, but permit where appropriate specific details such as the exact amount of payments to remain confidential.

Chapter 4 Principles for the Surveillance of Commodity Derivatives Markets

A. Introduction

Physical commodity derivatives markets are unique

The trading of physical commodity derivatives differs fundamentally from the trading of financial-based derivatives in that the actual supply of the underlying physical commodity is restricted to a finite supply. Notwithstanding the great diversity among the underlying commodities on which derivatives contracts are based, from the perspective of surveillance, physical commodity derivatives markets can be grouped according to their settlement provisions – physical delivery and cash-settled.

Commodity derivatives contracts that require the delivery of a physical commodity are most susceptible to manipulation when the deliverable supply on such contracts is small relative to the size of positions held by traders, individually or in related groups, as the contract approaches expiration.

A physical delivery contract's supply is usually further restricted beyond the naturally occurring finite amount of supply of the commodity in question by the contract's specification of what constitutes acceptable *deliverable supplies*. This specification is necessary in order to ensure consistency and thereby confidence. An increase in physical commodities prices may stimulate supply by making economically viable areas or techniques of production that were previously prohibitive. Nevertheless, this increased supply is affected by a time-lag, leaving short term dearth unalleviated. In the case of agricultural commodities, increased supply in times of shortage may not be available for months, or perhaps years in the case of cyclical increase of consumption.

The more difficult and costly it is to augment deliverable supplies within the time constraints of the expiring commodity derivatives contract's delivery terms, the more susceptible the contract is to squeezes and other forms of manipulation. Because of this concern, surveillance programs need to identify the buildup of large position concentrations, particularly during the settlement month.

Surveillance in cash-settled contracts emphasizes the integrity of the cash price series used to settle the futures contract. The size of a trader's position at the expiration of a cash-settled commodity derivatives contract generally should not affect the price of that contract (provided that there are no constraints on available supply)[41] because the trader cannot demand or make delivery of the underlying commodity.

These Surveillance Principles describe best practices for surveillance programs to detect manipulative or abusive conduct and to ensure to the extent possible the operation of fair and orderly physical commodity derivatives markets. The Principles reflect the accumulated experiences of Task Force members with respect to physical commodity markets and are intended to be of general application, as appropriate, to all commodity derivatives markets.

[41] See discussion on page 44.

These Principles also may be applied as appropriate to developing forms of electronic execution facilities for standardized OTC derivatives and in the context of clearing of both standardized and bespoke OTC derivatives contracts. The application of the Principles in such circumstances must be determined on a case-by-case basis by the relevant Market Authority, taking into account the type of contracts in question, the volume of trading, the type of market participants, whether the transactions perform a price discovery function or otherwise have an impact on other regulated markets, as well as the scope of the Market Authority's legal authority.

Finally, it is important to bear in mind that market surveillance is only one mechanism used to ensure market integrity and the orderly functioning of markets. These Principles, which also address disorderly markets, enforcement and information sharing, should therefore not be treated in isolation, but considered in conjunction with all of the Principles contained in this Report, as well as with other relevant IOSCO Principles, which in their entirety help promote market integrity and the orderly functioning of markets.[42]

B. Principles for Market Surveillance

Appropriate framework and resources

Principle: Framework for Undertaking Market Surveillance - *Market Authorities should have a clear and robust framework for conducting market surveillance, compliance and enforcement activities and there should be oversight of these activities. A market surveillance program should take account of a trader's related derivatives and physical market positions and transactions.*[43] *Market surveillance programs should be supported by sufficient resources, access to physical market data and analytical capabilities.*[44]

The general objective of a market surveillance program is to monitor the market in order to detect and deter manipulation or abusive trading that distorts prices, or disrupts trading or the physical delivery or cash-settlement of contracts, and to provide information that supports a Market Authority's enforcement actions. Each commodity derivatives market should have a clear and robust framework for conducting market surveillance and monitoring compliance with applicable laws, regulations and rules to achieve that objective. It is essential that the framework facilitates the hands-on supervision of markets, as well as the monitoring and analysis of market information through automated computer processes.

Essential elements include: monitoring the day-to-day, real-time trading activity in the markets (both real time as well as post trade), monitoring the conduct of market intermediaries through examination of business operations and collecting and analyzing trading information, typically analyzed on a T+1 basis.

The purpose of real-time monitoring of electronic trading is to ensure orderly trading and

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42 See also, for example: FR03/11 *Report on Trading of OTC Derivatives*, IOSCO, February 2011, fn 23 and *Recommendations for Central Counterparties*, Final Report of the IOSCO Technical Committee and the Committee on Payment and Settlement Systems, November 2004, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD176.pdf.

43 See p.15 *Task Force on Commodity Futures Markets*, Final Report, IOSCO, March 2009, fn 6.

44 See p.17 *Task Force on Commodity Futures Markets*, Final Report, IOSCO, March 2009, fn 6.

allow market operators to identify and correct any market or system anomalies on a timely basis. Real time monitoring of trading activity generally does not include data collection. For example, exchanges employ automated systems and human monitoring of the real time data to detect technical errors in the trading system as well as trading that indicates out-of-line prices, including possible *fat finger* errors. Post trade surveillance methods, which collect and analyze data (both using automated systems and human analysis) typically on a T+1 basis use order, transaction, and position data to detect trade practice abuses (including breach of position limits, *wash trades* , and *banging the close*[45].

Effective arrangements should be in place to permit Market Authorities to analyze on-exchange and related physical market and OTC derivatives activities, when needed, on an aggregated basis. When a large position is detected, a Market Authority should have the ability to collect information that permits it to identify positions under common ownership and control and to identify aggregate exposures.

The criteria for and definition of aggregation needs to be specified. In particular, such arrangements should be designed to offer a prompt and comprehensive overview of a market participant's overall position and activities in relation to the market and to related markets. These arrangements are necessary in order to assess a market participant's overall position and to gauge that trader's intentions including the possibility of delivery (or in the case of positions that are controlled by a third person that beneficial owner's intentions).[46] The framework for surveillance, compliance and enforcement should be adequately resourced to achieve these goals. This generally will require adequately skilled staff and automated analytical resources. *Adequacy* should take account of the size, structure and complexity of a jurisdiction's markets (exchange, OTC and physical). Market Authorities should take account of developing trends in markets and adapt their supervisory and enforcement policies and processes accordingly.[47]

Discussion

It is the responsibility of every Market Authority to ensure that a regulated derivatives market is free from such manipulation. This is also a commercial consideration because the ongoing confidence of its users is imperative. Markets in which prices can be easily manipulated are

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45 In 2010, the CFTC issued an order filing and simultaneously settling charges that Moore Capital Management, LP (MCM), Moore Capital Advisors, LLC (MCA), both based in New York, N.Y., and Moore Advisors, Ltd. (MA), a Bahamian entity (collectively Moore Capital), attempted to manipulate the settlement prices of platinum and palladium futures contracts on the New York Mercantile Exchange (NYMEX). The CFTC Order found that since at least November 2007 through May 2008, a former MCM portfolio manager (PM) attempted to manipulate the settlement prices of platinum and palladium futures contracts traded on the NYMEX by engaging in a practice known as "banging the close." Specifically, the former PM's orders were entered in a manner designed to exert upward pressure on the settlement prices of the platinum and palladium. Commodity Futures Trading Commission, April 29, 2010, available at http://www.cftc.gov/PressRoom/PressReleases/pr5815-10.html.

46 See discussion of beneficial ownership under the section below titled "Necessary Powers to Access and Collect Information and the Types of Information that is Needed for the Surveillance of Physical Commodity Derivatives Markets."

47 See *Approaches to Market Surveillance in Emerging Markets*, Report of the Emerging Markets Committee of IOSCO, 18 December 2009, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD313.pdf.

untrustworthy as price indicators or as trading mediums and will, therefore, suffer loss of confidence from market participants.

It is therefore in each market's own interest to ensure that it operates in a fair and orderly manner to ensure its continuing success. Additionally, it is the responsibility of exchanges' regulatory supervisors to ensure that this is done. An exchange that fails to keep its market free from manipulation or disorderly conditions should cause its regulator to ask whether regulatory interests are being pursued and conflicts managed or avoided.

In this regard, IOSCO Principle 8 should be noted. It requires that "the Regulator should seek to ensure that conflicts of interest and misalignment of incentives are avoided, eliminated, disclosed or otherwise managed. In the context of regulated markets, the regulator should take steps so that conflicts of interest or misalignment of incentives among regulated entities are avoided, eliminated, disclosed or otherwise managed."[48]

Although the focus of this Report is on market surveillance, a surveillance framework that monitors market participants' positions also serves a financial integrity function, as the identification of cleared large trader positions can be used to assess the financial exposures of a registered intermediary or clearing member. The collection and analysis of such financial exposure information also facilitates the identification of possible systemic risk that might be precipitated by the failure of a clearing member. In this respect, such monitoring also facilitates a governmental Market Authority's compliance with IOSCO Principle 6, which requires a regulator to have or contribute to a process to monitor, mitigate and manage systemic risk, appropriate to its mandate.[49]

> **Principle: Monitoring, Collecting and Analyzing Information –** *Market Authorities should develop, employ and maintain methods for monitoring of trading activity on the markets they supervise, collecting needed information and analyzing the information they collect that are efficient and suitable for the type of market being supervised. Effective monitoring of orders and electronic transactions requires real-time monitoring capabilities, supported by automated systems that detect trading anomalies. Monitoring, collection and analysis should also focus on intra-day trading.*

Monitoring is the act of observing price formation in a market and responding to that information, through automated means and by surveillance staff. Market Authorities should employ methods for monitoring markets that are efficient and suitable for the type of market trading platform and the amount of data to be monitored. This means practically that, for example, electronic markets should be monitored in real-time using technology that is commensurate with the speed and volumes of the electronic platform supervised. Such monitoring typically would focus on identifying any market or system anomalies. Automated surveillance systems which collect and analyze data to detect trading patterns and system anomalies should be in place to support such monitoring.

The same considerations apply to the collection and analysis of data. Data such as orders,

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[48] See Principle 8 *Objectives and Principles of Securities Regulation*, IOSCO, June 2010,fn 18. For example, a Market Authority might have rules that prohibit a market's enforcement/compliance staff from including staff whose interests conflict with their enforcement/compliance duties.

[49] Ibid Principle 6.

transaction and position information may be collected in real time, but are generally analyzed within a reasonable period soon after such collection, often T+1. Information should be collected on-line and in standard form by the trading platform, and by appropriate market participants, such as intermediaries for OTC transactions. Standardization of data collected across markets may be difficult to achieve initially but would, in due course, foster improved cross-border surveillance of linked international and domestic markets.

Speed is essential in monitoring information for market surveillance purposes. The advent of sophisticated algorithmic trading strategies, combined with high speed data connections, has changed the structure of markets. Trading strategies based on microsecond positions that are quickly terminated potentially may allow for intra-day abusive trading schemes. It follows that market monitoring should be based on automated electronic methods, such as automated trading alerts. Subsequently, collected data should be analyzed to detect possible intra-day trading abuses.

Discussion

Traditionally, surveillance of physical delivery commodity futures markets has focused on issues of market power at expiration. That focus reflects the fact that physical delivery futures contracts are most susceptible to manipulation when the deliverable supply on such contracts is small relative to the size of positions held by traders, individually or in related groups, as the contract approaches expiration.[50]

In order to address these concerns, Market Authorities traditionally have focused on ensuring that a balance between long and short positions is not disrupted throughout the trading months and in particular, generally heighten scrutiny as a contract approaches delivery. Market Authorities generally monitor end-of-day positions in markets and, through the use of large trader identification techniques (discussed later in this Report); will contact the holders of any large concentrations to ascertain the intentions of a suspect trade. Pertinent questions that address this concern in physical delivery markets include:

- Are the positions held by the largest long traders greater in size than deliverable supplies not already owned by such trader(s)?
- Are the long traders likely to demand delivery?
- Is taking delivery the least costly means of acquiring the commodity?
- To what extent are the largest short traders capable of making delivery?
- Is making futures delivery a better alternative than selling the commodity in the cash market?

[50] For example, in June 2010 the UK Financial Services Authority fined a commodity broker for market abuse and banned the broker from working in the financial services industry. The broker deliberately manipulated the market in London International Financial Futures and Option Exchange (LIFFE) traded coffee futures and the related coffee futures options. Implementing a plan previously developed with his client, the broker executed trades during a one minute period of trading in order to increase artificially the price of coffee futures. FSA/PN088/2010 *FSA fines and bans commodity broker for market abuse*, 2 June 2010, available at http://www.fsa.gov.uk/pages/Library/Communication/PR/2010/088.shtml.

- Does the futures price, as the contract approaches expiration, reflect the cash market value of the deliverable commodity?

- Is the cash price series representative of physical commodity market transactions that have taken place and may or may not be reported to a price reporting agency?

- Is the price spread between the expiring future and the next delivery month reflective of underlying supply and demand conditions in the underlying physical commodity market?

An excellent barometer for potential liquidation problems is the basis relationship (*i.e.*, the difference between cash and futures price). When the price of the liquidating future is abnormally higher than underlying physical commodity prices or comparable futures prices, or both the futures and underlying physical commodity price are abnormally higher than comparable prices there is ample reason to examine the causes and to assess the motives of traders holding sizable long futures positions.

Since manipulation of the cash market can yield a profit in the futures contract, Market Authorities' staff should monitor large reportable futures positions and be alert for any unusual cash market activity on the part of large futures traders. This is especially the case during the time that the final cash price for futures settlement is determined. Additionally, as stated previously, the surveillance emphasis in cash-settled contracts is on the integrity of the cash price series used to settle the futures contract.

Examples of some pertinent surveillance questions for these markets are:

- As the futures contract expiration approaches, is the cash price moving in a manner consistent with supply and demand factors and with other comparable cash prices, which are not used in the cash-settlement process?

- Do traders with large positions in the expiring future have the capacity and ability to affect the cash price series used to settle the futures contract?

- What information can be obtained from the organization that compiles the cash price series regarding how the price is determined?

- Is anyone reporting prices that appear to be out of line with prices reported by others? If yes, can it be determined that the party reporting those prices holds a futures position that would benefit by those prices?

Finally, the continued technological evolution of markets and an increase in the number and composition of traders who participate in commodity derivatives markets (i.e. the *financialization* of commodity markets) carry many benefits (e.g., greater liquidity, which in turn provides greater hedging opportunities at lower costs), they however also broaden the opportunities for abusive or manipulative trading.

Market Authorities in general have responded to the evolution of markets by similarly evolving their market surveillance techniques and routinely employing real-time monitoring

procedures, including automated alerts, and analyzing data on a T+1 basis.

In the case of high frequency trading, in which positions may be entered and closed tens of thousands of times during a trading session, Market Authorities should adopt surveillance technologies that are capable of identifying, within an intra-day time frame, abusive trading that is conducted on a high frequency basis. Market Authorities should have adequate tools to analyze the data, including the order book, trade executions, and intra-day prices, to identify the unique characteristics of disruptive trading by high frequency trading. After identifying what abusive high frequency trading *looks like* the abuses may be easier to monitor and prevent.[51]

Authority to Access and Collect Information and the Types of Information that are Needed for the Surveillance of Physical Commodity Derivatives Markets

> **Principle: Authority to Access information -** *Market Authorities should have the authority to access information on a routine and non-routine basis for regulated commodity derivatives markets as well as the power to obtain information on a market participant's positions in related over-the-counter (OTC) commodity derivatives and the underlying physical commodity markets. In particular, Market Authorities should have the power to:*
>
> *i) access information that allows the reconstruction of all transactions on a regulated commodity derivatives market (audit trail);*
>
> *ii) access information that permits them to identify large positions (i.e., "large exposures" or "concentrations") and the composition of the market in question;*
>
> *iii) access information, if needed, on the size and beneficial ownership of positions held by a market participant in order to aggregate positions held under common ownership and control;*[52]
>
> *iv) access information about a market participant's transactions and positions in related OTC and physical commodity markets; and*
>
> *v) take appropriate action where a commodity derivatives market participant does not make requested market information*[53] *available to the Market Authority.*
>
> *Market Authorities should review the scope of their authority to obtain such information and if necessary to request such power from the relevant legislature or*

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51 See, in this regard, the consultation report *CR02/11 Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency*, July 2011, fn 6.

52 See Section 13.7, ¶3, first sentence, *Objectives and Principles of Securities Regulation*, Report of the Executive Committee of IOSCO, February 2008, available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD265.pdf.

53 Such as requests for related OTC and physical commodity market positions or clarification of the end-beneficiary to a trade to determine positions that may be held under a common ownership or control.

other appropriate governmental bodies.[54]

Principle: Collection of Information on On-Exchange Transactions – *In respect to on-exchange commodity derivatives transactions, a Market Authority should collect information on a routine and regular basis on:*

i) pricing of contracts throughout the trading day in real time;

ii) daily transactional information including time and date of trade, commodity contract, delivery month, expiry date, buy/sell, quantity, counterparties to the contract, and price of the contract;

iii) daily reports of end-of-day positions held by market intermediaries (both "whole firm" and by individual trader) and by other market participants, where the size of the position is above a specified level ("large position"). Information collected should permit a Market Authority to identify each position holder (by name or code) down to the first customer level, and the size of position, by contract month, for each position holder;

The Market Authority should have the capability to aggregate position holder information promptly in order to identify positions under common ownership or control; and

iv) where appropriate, warehouse stocks or other deliverable supply.[55]

Principle: Collection of OTC Information – *In respect of OTC commodity derivatives transactions and positions, a Market Authority should consider what information it should collect on a routine basis and what it should collect on an "as needed" basis. A Market Authority that has access to a relevant Trade Repository's (TR) data should take such broader access into account, as well as its statutory obligations with respect to the TR, in constructing its data collection policies.*

Information could include, as appropriate:

For information collected on a routine basis:

i) transactional information including time and date of transaction, contract terms, counterparties to the contract and price of contract; and

ii) position information.

For information collected on an "as needed" basis:

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54 See *Task Force on Commodity Futures Markets*, Final Report, IOSCO, March 2009, fn 6

55 Warehouse stocks and verifiable deliverable supply reveal the quantities truly available for delivery when the contract terminates with open positions (that are not closed out). Market surveillance uses this information in the days preceding contract termination to verbally communicate with traders to reduce or close out large positions to ensure that the contract terminates in an orderly manner. Surveillance staff can also detect potential manipulation (squeezes and corners) by checking the trading positions for holders of large warehouse stocks and supplies.

i) delivery intentions

ii) beneficial owners;

iii) positions under common control;

iv) for contracts other than forwards, additional information may also need to be sought on notional values, replacement cost, valuation methodology or duration of the contracts.

For physical commodity derivatives markets, information is a critical tool for maintaining fair and orderly markets and ensuring market integrity.[56] Information about transactions permits a Market Authority to detect customer and market abuses. Information about futures, and related OTC and physical market positions, as appropriate, allows Market Authorities to identify large positions which could potentially result in a disorderly market or relate to market abuse, evaluate the overall composition of the market and to assess its functioning.

Obtaining this information is particularly critical during periods of significant and abrupt price movements (e.g., high price volatility) in order to determine whether a market is functioning properly.

Obtaining position information also enables Market Authorities to understand the composition of the market and to analyze the participation of various classes of traders such as commercial and non-commercial market participants.

In order to determine large concentrations of positions and thereby apply position limits and carry out position management, Market Authorities must have powers to obtain information from market members that enable the Market Authority to determine positions that are held under common ownership and control.

A broker's direct client (i.e., first customer level) who signed the account documentation in reality may be operating on behalf of an unknown person who controls the account (the beneficial owner). A Market Authority must be able to identify such a beneficial owner in order to aggregate positions. Brokerage policies generally require the broker's direct client to disclose only its immediate beneficial owners (i.e., the client's immediate controlling person). However, such disclosure may not reveal additional layers of control. In order to obtain the identity of an account's ultimate owner, a Market Authority might need to request information from successive layers of beneficial owners. A variety of powers may be necessary to accomplish this, such as the power to order a market to trade for liquidation only with respect to a trader's positions if the trader does not provide the requested information or the use of subpoena power by an appropriate authority to require the production of the requested information.

The development of trade repositories for OTC instruments will facilitate access to previously opaque OTC transaction data. The availability of this information should prompt Market Authorities to evaluate the scope, frequency and utility of accessing such information.

[56] For further information on the types of information useful to manage price readjustment or volatility in a particular contract, see IOSCO report *Guidance on Information Sharing* (1997).

Market Authorities should monitor the development of international guidance in this regard.[57]

Discussion - Access to and Collection of Information

For on-exchange and related OTC transactions, Market Authorities should have authority to collect non-routine information including information from authorized firms about the identity of the traders and the beneficial owners of commonly owned or controlled positions.

Information may also be sought about the existence, size and nature of a related physical commodity or OTC position (including for example whether part of a hedge, arbitrage or other risk management strategy), about the granting of credit to and utilization of credit by customers and about delivery intentions.

Obtaining information about physical commodity market transactions may currently not be quite straightforward in some jurisdictions but is important in order to ascertain a market participant's delivery intentions with regard to an exchange-traded contract as well as to understand the effect of such physical market transactions on price formation in the physical market. Access to physical market transaction data, both physical spot market for immediate delivery and forward contracts calling for delivery in the immediate future, is important for market surveillance to assess the reliability of price indexes.

For omnibus accounts, information should be collected to appropriately identify ultimate beneficiaries or positions under common control. In order to obtain the identity of an account's ultimate owner/controller, a Market Authority might need to request information from successive layers of market participants who may be acting as beneficial owners.[58] A variety of powers may be necessary to accomplish this, such as a rule that requires a market participant to disclose whether, and if so, for whom, it is acting as a beneficial owner.[59]

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[57] See, e.g. IOSCO-CPSS work-streams, *Report on OTC Derivatives Data Reporting and Aggregation Requirements*, CPSS-IOSCO, August 2011, fn 25.

See also CFTC Final Rule: *Significant Price Discovery Contracts (SPDC) on Exempt Commercial Markets, 74 Federal Register 12178,*,March 23, 2009, available at http://www.federalregister.gov/articles/2009/03/23/E9-6044/significant-price-discovery-contracts-on-exempt-commercial-markets. The SPDC rule establishes criteria for determining when a commodity derivative traded on an exempt market serves a significant price discovery function and impacts on contracts traded on a comprehensively regulated futures exchange. Because the SPDC determination triggers heightened oversight, it could be instructive for Market Authorities seeking to determine when to apply heightened surveillance scrutiny to OTC derivatives.

[58] In cases where omnibus accounts are used by an intermediary "A", the intermediary's omnibus account is the "first level" customer of the clearing firm "B." The omnibus account information submitted by the clearing member "B" to a Market Authority therefore will show only the aggregate positions held in the omnibus account owned by intermediary "A." (the clearing member's client). However, information on the individual holdings of the intermediary's individual clients could be obtained by accessing the information directly from the omnibus account owner "A." Nothing in this Report should be interpreted as requiring an omnibus account to be structured so as to disclose separately to the clearing member in the ordinary course of business the individual clients who submitted the trades for execution.

[59] See, e.g., CFTC Part 18 reports by traders and rule 18.04(a)(5), (6) and (7), which require a reporting trader to identify each person who controls the trading of the reporting trader and to identify the names and locations of all brokers which carry accounts owned or controlled by the reporting trader. If a reporting trader does not submit such information, CFTC rule 21.03 (f) authorizes the CFTC to notify the relevant exchange of such non-compliance with its request for information and the exchange "shall prohibit" the execution of transactions unless such trades offset existing open contracts (i.e., trade for

The goal of improving the ability of Market Authorities to access potentially useful information is not a blanket recommendation for the general imposition of mandatory routine reporting requirements. However, regulators may need the authority to collect information from parties not participating directly in regulated commodity derivatives 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. Market surveillance is resource sensitive, although it is generally neither physically possible nor necessary to scrutinize every trade, or every position, to form an understanding of market activity. However, in an investigation for market manipulation, it may often be necessary to reconstruct the entire trading record.

> **Principle: Large Positions** – *Market Authorities should require the reporting of large trader positions for the relevant on-exchange commodity derivatives contracts. The Market Authority should have the ability to aggregate positions owned by, or beneficially controlled on behalf of, a common owner.*

In order to identify the buildup of concentrations of positions that could result in congestion or price distortion or evidence a possible manipulation or other abusive trading, Market Authorities must be aware of large positions and their owners (including positions owned or controlled by a third party on behalf of such true owner), and may need additional information on related OTC and physical market positions. Obtaining such information across these markets assists Market Authorities in determining a large trader's intentions in respect of a particular commodity.

This Principle should not be interpreted as limiting the reporting procedures that Market Authorities may implement as long as the objective of identifying and monitoring large concentrations is achieved. For example, the Principle can be met by *ad hoc* reporting by traders holding a large position to a Market Authority. Similarly, it could be met (1) where the owners and beneficial owners of each trading account are reported to a Market Authority (*e.g.*, an exchange) at the time of account opening and (2) the Market Authority receives reports from the clearinghouse or clearing members of ongoing transactions and/or clearing data that allow the Market Authority to identify large account holders on an aggregated basis and monitor large concentrations.

The determination of what constitutes a "large position" should be made by the relevant Market Authority acting within its discretion, taking into account the size and composition of the market in question. It follows that not every market will have the same exposure monitoring needs, trigger levels or approach to monitoring. Market Authorities should establish qualitative or quantitative criteria that are used to identify such large exposures (trigger levels).[60] The relevant Market Authority should ensure that the definition of large positions and any "trigger" levels are made clear to market participants.

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liquidation only).

60 See ¶13.7 *Objectives and Principles of Securities Regulation*, IOSCO, February 2008, fn 52.

Discussion

Identifying Large Positions

The relationship between the size of a position, the trading intention behind it and the owner is of vital importance in the Market Authority's decision-making process with regard to a large position. The justification for holding a large position may well rest on the business function of the owner. A commercial market participant with large delivery commitments may well be able to justify a large position in a commodity derivatives contract, but a non-commercial market participant with a similar position may find it more difficult to argue the case. Therefore, Market Authorities should have mechanisms (e.g., reporting, monitoring) in place to ensure that they are fully aware of the large positions in existence, the owner of the positions and the reasons for the positions. A Market Authority should have procedures in place to alert it to all positions held by any market participants which breach pre-determined levels.

These levels will necessarily vary between different markets and contracts, and should be subject to regular review to ensure that they are appropriate for prevailing market conditions. It may well be that a market participant with malign intent might seek to conceal from the Market Authority his intentions and therefore hold positions across a number of market members. Reportable position levels should therefore be set at a level well below levels which might represent a threat to the integrity of the market. However, Market Authorities' should not be constrained in their actions by pre-determined reportable levels.

Identifying positions under common ownership and control - Aggregation

The ability to identify and aggregate positions that are owned or controlled by a common owner is critical to determining accurately "large positions." For example, it is not unusual for a large corporation to have multiple trading operations trading independently for different purposes (e.g., commercial hedging, proprietary trading, and non-commercial trading). Yet those positions are ultimately under common ownership and control and should be aggregated for purposes of identifying and responding to a large position.

In order to enable efficient identification of positions on an aggregated basis, Market Authorities should be able to access information as to the name of the owner of each reportable position. Further, commodity derivatives markets should prohibit market participants trading under fictitious names or acting undisclosed for a third party. Market Authorities should adopt effective mechanisms that will enable them to identify such common ownership.

The fulfillment of the G20 Commitments with respect to OTC derivatives will result in the availability to Market Authorities of increased data on OTC transactions. Market Authorities should therefore evaluate means to incorporate this OTC data into their market surveillance programs, including into their approaches for identifying large concentrations. This will require Market Authorities to determine whether a particular futures contract should be aggregated with a similar OTC derivatives contract for purposes of applying position management including position limits to such a common derivatives position. Market Authorities should monitor the ongoing development of international[61] and national

[61] See *Report on OTC Derivatives Data Reporting and Aggregation Requirements*, CPSS-IOSCO, August

initiatives[62] that might be instructive in this regard.

To better understand the composition of the market, Market Authorities should consider adopting a system of internationally consistent account classifications for international markets that have significant cross-border impacts to distinguish the various types of trading, such as commercial trading. The analysis of such classifications is complex. For example, a trader may be classified as a commercial in some commodities and as a non-commercial in another. Moreover, these classifications may change quickly over time.

Although such standardization would facilitate analysis across a jurisdiction's markets, any analysis of global markets would require that data sets be comparable internationally. Market Authorities should consider the utility and feasibility of harmonizing reporting classifications in order to achieve such comparable data sets.

2011, fn 25.

[62] See, e.g., CFTC final regulations regarding large trader reporting for physical commodity swaps Federal Register 43851 (July 22, 2011), which among other things proposed criteria to identify a subset of swaps ("paired swaps") that are economically-equivalent to related futures contracts. Such criteria will be necessary to permit the application of position limits on an aggregated basis across a market participant's futures and swaps positions.

Chapter 5 Principles to Address Disorderly Commodity Derivatives Markets

A. Introduction

With respect to derivatives markets, an orderly market may be characterized by, among other things, parameters such as a rational relationship between consecutive prices, a strong correlation between price changes and the volume of trades, accurate relationships between the price of a derivative and the underlying commodity and reasonable spreads between near and far dated contracts. Numerous conditions can negatively affect trading and the characteristics of an orderly market, ranging from technical errors in the trading system, "fat finger" mistakes, overreactions to major news or rumors such as embargoes or natural disasters that might affect supplies of commodities, or an unmanaged imbalance between long and short positions resulting from large concentrated positions.

The IOSCO Principles state that one of the key objectives of regulation is to ensure that markets are fair, efficient and transparent.[63] The IOSCO Principles address these concerns in the context of organized markets through the Principles relating to Secondary Markets.[64] Those Principles require, among other things, that trading systems be subject to regulatory authorization and continuing oversight prevails as a means to ensure fair and orderly markets,[65] regulation should be designed to detect and deter manipulation and other unfair trading practices,[66] and regulation should aim to ensure the proper management of large exposures, default risk and market disruption.[67] The specific application of these Principles is further refined in IOSCO's Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation.[68]

Additionally, IOSCO has produced numerous reports, which discuss the specific application of various regulatory tools such as trading halts, error trade policies and electronic access controls as a means to address disorderly markets.[69] Those reports, which have general application to all

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63 *Objectives and Principles of Securities Regulation*, IOSCO, June 2010, fn 18.

64 Ibid Principles 33 through 38.

65 Ibid Principles 33 and 34.

66 Ibid Principle 36.

67 Ibid Principle 37.

68 *Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation*, Executive Committee of IOSCO, February 2008 – Internal Document.

69 See *Principles for Direct Electronic Access to Markets*, Final Report of the Technical Committee of IOSCO, 12 August 2010), available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD332.pdf;

See *Policies on Error Trades*, Report of the Technical Committee of IOSCO, October 2005, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD208.pdf;

See *Trading Halts and Market Closures*, Report of the Technical Committee of IOSCO, October 2002, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD138.pdf;

See *Screen-Based Trading Systems for Derivatives Products*, Report of the Technical Committee of IOSCO, June 1990, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD6.pdf; and

See Principles for the Oversight of Screen-Based Trading Systems for Derivative Products-Review and Additions, Report of the Technical Committee of IOSCO, October 2000, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD111.pdf.

markets, both equity and derivatives, should be consulted, as the purpose of this Report is not to revisit issues of general application to markets.[70]

Accordingly, this Report focuses on regulatory tools to address disorderly markets that are particularly relevant to commodity derivatives markets.

B. Principles

Principle: Intervention Powers in the Market - *Market Authorities should have, and use, effective powers to intervene in commodity derivatives markets to prevent or address disorderly markets and to ensure the efficiency of the markets. These powers should include the following:*

1) Position Management Powers, Including the Power to Set Position Limits - *Market Authorities should have and use formal position management powers, including the power to set ex-ante position limits, particularly in the delivery month,.*

These should necessarily include position management powers that:

i) Establish a trader's automatic consent to follow an order of the Market Authority when that trader's position reaches a defined threshold size or any size, which the Market Authority considers prejudicial to orderly market functioning, taking into account all relevant circumstances. They should also require such a trader to comply with the Market Authority's order, either not to increase a position or to decrease a position; and

ii) Authorize a Market Authority to place ex-ante restrictions on the size of a position a market participant can take in a commodity derivatives contract (i.e., position limits).

2) Other Discretionary Powers - *Market Authorities should also have the powers to employ any of the following measures, as appropriate to address market disruption or the perceived threat of such disruption or to assist market surveillance efforts:*

i) the imposition of price movement limits;

ii) calling for additional margin, either from customers or from clearing members on behalf of their clients;

iii) ordering the liquidation or transfer of open positions;

iv) suspending or curtailing trading on the market (e.g., trading halts and circuit breakers);

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[70] See *CR02/11 Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency*, July 2011, fn 6.which addresses the impact of technology such as high frequency trading on markets.

v) altering the delivery terms or conditions;

vi) cancelling trades;

vii) requiring owners of positions to specify delivery intentions; and

viii) requiring traders to disclose related OTC derivatives or large physical market positions.

Disorderly conditions in physical commodity derivatives markets can have significant negative effects on national economies. Accordingly, it is critical that Market Authorities have the necessary powers to intervene in the markets to address disorderly conditions. In particular, there should be a credible use by Market Authorities of powers to stabilize markets should disorderly conditions exist, including by ordering market participants to reduce the levels of their positions if that outcome is deemed necessary by the relevant Market Authority.[71] The flexibility provided by position management powers, which includes the use of position limits, to intervene where specific circumstances so require is an effective way of preventing manipulation and disorderly markets arising from large positions (e.g. amassed close to the settlement date of physical delivery), especially concerning participants that are not hedging their positions in the physical markets.

Discussion

Market Authorities have developed a range of approaches to address the fundamental principle that they must be empowered to take action over positions of potential concern to orderly markets, of potential manipulation or for any other reason they reasonably judge appropriate. The evolution of these approaches inevitably reflects a Market Authority's applicable legislation or rules,[72] its market philosophies, regulatory experiences and business practices. The powers enumerated in the above Principle reflect those powers that Market Authorities have found to be appropriate to deal with disorderly markets.

It is not enough, of course, to merely have a catalog of powers, they must be used where appropriate. What is most important however is for Market Authorities to use their surveillance capabilities in a coherent and ongoing manner to identify developing disorderly conditions and take action accordingly.

Position Management Powers, Including Power to Set Position Limits

The G20 Finance Ministers called on IOSCO to include in its recommendations on regulation and supervision of derivatives markets "formalized position management powers, including

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[71] The use of position management techniques, which include the power to set ex-ante position limits, is a mandatory requirement under this Principle. *See* Communiqué Meeting of Finance Ministers and Central Bank Governors, Washington, DC, 14-15 April 2011, available at http://www.G20.org/Documents2011/04/G20%20Washington%2014-15%20April%202011%20-%20final%20communique.pdf.

[72] See, e.g. proposed regulations regarding limits for derivatives, 76 *Federal Register* 4752 (January 26, 2011), for a historical review of how position limit policy has evolved in the United States. http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-1154a.pdf.

the authority to set ex-ante position limits where appropriate among other powers of interventions."[73]

As used in this Report, the term "position management" refers collectively to both (1) the retention of discretionary power to respond to identified large concentrations, but without pre-determined restrictions on the size of positions that a market participant may own or control and (2) fixed position limits, which are predetermined absolute limits on position ownership in the spot or delivery month and/or in later months. Many jurisdictions employ both techniques, with the main differences between them being where the emphasis lies.

The use of position management, including position limits, is well established in organized future markets as a means to address the potential for large positions in commodity futures and options markets to prejudice orderly market functioning. This is because the capacity of a market to absorb the establishment and liquidation of large positions in an orderly manner is related to the size of such positions relative to the market and the market's structure and is not unlimited.[74]

There is a temporal element to be considered when addressing this problem. Specifically, futures contracts are most susceptible to manipulation when the deliverable supply on such contracts is small relative to the size of positions as the contract approaches expiration and open interest generally becomes progressively smaller. The more difficult and costly it is to augment deliverable supplies within the time constraints of the expiring futures contract's delivery terms, the more susceptible to manipulation and congestion the contract becomes.

When large positions are amassed in a contract, or contract month – sometimes with manipulative intent – the potential exists for unreasonable and abrupt price movements should the positions be traded out or liquidated in a disorderly manner. Trading under such conditions can result in greater volatility than would otherwise prevail if traders' positions were more evenly distributed among market participants. Although this risk exists throughout the life of a contract, it is highest when a deliverable contract approaches its expiration.[75] Contracts that are cash settled do not necessarily avoid this risk. This is because arbitrage implies that cash settled contracts will settle at, or very near, the price of the underlying at the time of expiration. Hence, a participant controlling a significant portion of the available inventory can influence the cash price by either of two routes. By not selling, supplies available to the market are made scarce and prices are expected to rise. Alternately, by threatening to sell a large amount, available supply increases and prices will fall. The incentive for this inventory holder to exert those influences will increase with the extent of the futures positions held.

- **Establishing a trader's automatic consent to follow an order to reduce a position**

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[73] See *Final Communiqué Meeting of Finance Ministers and Central Bank Governors*, Washington, DC, 14-15 April 2011, fn 5. For purposes of this Report, the term "position management" is used expansively to include the authority to set position limits. National jurisdictions may use different terminology.

[74] See, e.g. CFTC position limit proposal at 76 *Federal Register* 4755, January 26, 2011, available at http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-1154a.pdf. .

[75] See ¶9.7, p. 32 *Reforming OTC Derivatives Markets: A UK Perspective*, FSA/HM Treasury, December 2009, available at http://www.fsa.gov.uk/pubs/other/reform_otc_derivatives.pdf.

One position management approach establishes a trader's automatic consent to follow an order of the exchange when that trader's position reaches either a defined threshold size or any size which a Market Authority considers may be prejudicial to market functioning, taking account of all relevant circumstances. This approach requires such a trader to comply with the exchange's order, either not to increase a position or to decrease a position. This approach represents the application of the principle that Market Authorities should be empowered to take action over any position of potential concern.

In many jurisdictions, Market Authorities apply this approach to all positions on the commodity market, although in certain jurisdictions this is refined to apply to all positions which exceed a pre-determined accountability limit. Typically, the market's rules give exchanges the authority to manage positions at any time during the contract's life cycle and to instruct a member to close or reduce a position with the exchange, if that is necessary, to secure fair and orderly markets. If the exchange member does not comply, the exchange has the power to close the position unilaterally.[76] In many jurisdictions, the exchange's discretion to act is subject to the overriding authority of the governmental Market Authority, which is empowered to force the exchange's hand in cases where the governmental Market Authority considers action should be taken. The governmental Market Authority also uses its authority over regulated market participants, such as intermediaries, to enforce actions relating to positions directly.

- **Position Limits**

In certain jurisdictions the approach to addressing positions of potential concern has gravitated towards pre-determined fixed position limits, particularly in the delivery month. The imposition of fixed position limits is viewed primarily as a tool that seeks to prevent market concentration in advance by establishing set limits of non-commercial involvement in a contract at various months of the contract's trading cycle. Typically, there are three elements of a position limit regime: the levels of the limits, the exemptions from them (in particular for hedgers) and the policy on aggregating accounts. Limits are generally set in reference to historical levels of the open interest in a contract. As noted above, the temporal nature of a contract's susceptibility to manipulation or congestion ordinarily results in different limits as applied to the "spot" month and other future maturities. Some approaches combine the application of fixed position limits in the spot month with position management in farther out months.

A fixed position limit regime generally requires classification of market participants into commercial and non-commercial categories, analysis of a contract's historical open interest and exemptions from those limits for hedging by *bona fide* commercial users of the commodity contract in question.

Finally, because position limits essentially are concerned with limiting market concentration, an effective position limit regime must have an effective mechanism to identify and aggregate positions that are owned or controlled by a common owner, as required by the Principle on Large Positions.

[76] Ibid at ¶¶ 9.12 – 9.15.

Market Authorities should use their position management powers to address disorderly markets

In order to manage large concentrations in commodity derivatives markets, Market Authorities should have and use formal position management powers, including the power to set ex-ante position limits. The decision to rely on fixed ex-ante position limits or the power to establish a trader's consent to follow an order of the exchange or a combined approach as the primary mechanism to address position concentrations and disorderly markets,[77] will inevitably reflect a Market Authority's applicable legislation, or rules, its market philosophies, regulatory experiences and business customs and practices.

The Task Force concludes therefore that it is appropriate for all Market Authorities to adopt and use position management, including the power to set position limits, *particularly in the delivery month where appropriate,* among other powers of intervention.[78] In practice Market Authorities have used a combination of the two approaches, with differences in *emphasis*. Regardless of the approach taken, there should be a credible use by Market Authorities of powers to stabilize markets should disorderly conditions exist, including by ordering market participants to reduce the levels of their positions if that outcome is deemed necessary by the relevant Market Authority.

Price limits and Trading Halts

Price limits, which set boundaries for daily price moves, price-quality bands, trading halts and circuit breakers[79] have been used by markets to address market volatility.

Market Authorities may adopt price limits, trading halts and circuit breakers to:

1) reduce or constrain price movements in a trading day that are perceived by Market Authorities as not being reflective of true market conditions, but might be caused by traders overreacting to new information;

2) provide a cooling off period for futures market participants to respond to *bona fide*

[77] In the United States, the framework for addressing threats of manipulation and congestion has included both federally mandated position limits in certain contracts, position limits in other contracts fixed by exchanges and (since 1991) position accountability exemptions. See 76 *Federal Register* 4752, 4755 (January 26, 2011).

[78] The Task Force notes that the Committee of European Securities Markets Authorities (now the European Securities Market Authority (ESMA)) in its technical advice to the European Commission in connection with the Commission's review of MiFID also reached the conclusion that it is appropriate for Market Authorities to adopt position management powers. The Task Force also notes the proposal of the European Commission within its public consultation on the MiFID review (December 2010) to amend the framework directive to grant a heightened form of position management, to introduce greater coordination at EU level in the application of those powers and to allow for the adoption of implementing measures setting ex-ante position limits both for derivative contracts traded on exchange and OTC (p.83), in line with the US framework. http://www.esma.europa.eu/index.php?page=document_details&from_title=Documents&id=7279 http://ec.europa.eu/internal_market/consultations/docs/2010/mifid/consultation_paper_en.pdf.

[79] For a detailed review of these mechanisms, see FR09/11 *Effectiveness of Market Interventions in Emerging Markets*, Report of Emerging Markets Committee of IOSCO, 15 October 2010, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD333.pdf.

changes in market supply and demand fundamentals that would lead to large cash and commodity derivatives contracts price changes;

3) allow additional time for the collection of margins in times of large price movements;

4) prevent excessive collateral damage to other market participants who base their trading on market levels created through error[80];and

5) enable Market Authorities to develop appropriate responses in the circumstances.[81]

If price limits are adopted, they should be set at levels that are not overly restrictive in relation to price movements in the physical market.

> **Principle: Review of Evolving Practices** - *Market Authorities should have or contribute to a process to review the perimeter of regulation to ensure that they have the power to address evolving trading practices that might result in a disorderly market. Exchanges and self-regulatory organizations play a critical and complementary role with governmental regulators in identifying such practices.*

The dynamic nature of markets requires Market Authorities to assess whether their existing policies are adequate to address changing market structures, trading technologies and practices. Market Authorities should therefore review their existing powers in light of changing market conditions and, if necessary, seek additional powers as appropriate.

Discussion

IOSCO Principle 7 requires a regulator to have or contribute to a process to review the perimeter of regulation regularly.[82] In this connection, concerns have been raised by regulators that new trading technologies, such as high frequency trading, and specific methods (e.g., spoofing or bidding or offering with the intent to cancel the bid or offer before execution, the order not submitted as part of a legitimate, good-faith attempt to consummate a trade) may foster conditions that inadvertently result in market disruption, which may not fall within existing prohibitions or rise to the level of intentional abuse, but nonetheless disrupt trading (disruptive practices).[83]

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80 See *Policies on Error Trade*, IOSCO, October 2005, fn 69.

81 Some US Market Authorities also have rules for the automatic expansion of the daily price limit after consecutive days of limit bid/offer prices. Some electronic trading platforms also have ‘‘reasonability tests’’ and/or ‘‘price bands’’ for order entry, which do not allow an order to enter the trade matching system if it is outside a predetermined price range or is of a particularly large size.

82 *Objectives and Principles of Securities Regulation*, IOSCO, June 2010, fn 18.

83 See, e.g. Consultation paper : *Guidelines on systems and controls in a highly automated trading environment for trading platforms, investment firms and competent authorities*, European Securities and Markets Authority, 20 July 2011 available at http://www.esma.europa.eu/popup2.php?id=7675. A Joint CFTC-SEC Advisory Committee, which was created soon after the May 11, 2010 “flash crash”, is examining emerging regulatory risks. The Advisory Committee published a report, which among other things, questioned whether it is ever appropriate to permit large order algorithms that employ unlimited use of market orders or that permit executions at prices which are a dramatic percentage below the present market price without a pause for human review. http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/jacreport_021811.pdf. Technical Committee Standing Committee on Secondary Markets is investigating HFT as well.

In order to meet these evolving practices, Market Authorities should review the adequacy of existing prohibitions to ensure that they address evolving disruptive practices that a Market Authority identifies and meet any relevant international guidelines. Such prohibitions might be developed that are market specific to take account of particular features of the underlying physical commodity, or more general to encompass the regulated market as a whole.[84]

In carrying this Principle forward, there should be complementary efforts among Market Authorities, including governmental regulators, SROs and markets. Governmental regulators should clearly articulate through rules any new prohibitions which require public input. Markets and other SROs, which have self-regulatory obligations to ensure orderly markets, should have the flexibility to adopt and adapt their own policies to address disruption of the market in question.

[84] See, e.g., *Proposed Interpretative Order on Anti-Disruptive Practices* at 76 Federal Register 14943, 14946, March 18, 2011, available at http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-6398a.pdf.

Chapter 6 Principles for Enforcement and Information Sharing

A. Introduction

This section addresses the powers that are needed to prohibit, investigate and take enforcement action against market abuses, as well as the need for information sharing among Market Authorities. Traditionally, the application of such powers has taken place within the context of activities on an individual market. The Principles discussed in this section address this context. However, that one dimensional focus is not adequate to address the realities of abusive trading schemes, which involve conduct extending beyond an individual futures exchange to include conduct in the OTC derivatives markets and the underlying physical commodity markets. An effective response to these sophisticated multi-market abusive trading schemes demands an active and coordinated enforcement structure having the necessary powers to detect and address multi-market schemes. Each jurisdiction may need to evaluate its existing programs and legal authorities to ensure that its surveillance and enforcement framework and legal powers are adequate to address multi-market abuses.

B. Principles

Principle: Rules and Compliance Programs - *Market Authorities should have rules, compliance programs, sanctioning policies and powers to prohibit, detect, prevent and deter abusive practices on their markets, including manipulation or attempted manipulation of the market. The rules and compliance programs should take account of the whole position of the market participant (i.e., all positions under common ownership and control). There should be clarity as to what constitutes manipulative, abusive conduct or other prohibited conduct.*

Specific practices which Market Authorities should seek to detect and prevent include, among others:

i) causing, or attempting to cause, artificial pricing in the market;

ii) creating a false or misleading appearance of active trading;

iii) disseminating false or misleading information in respect of the market or conditions that affect the price of any commodity derivatives contract;

iv) creating, or attempting to create, a corner or squeeze, in which an abusive controlling position is accumulated in the physical and/or futures or OTC markets, forcing those holding short positions to settle their obligations, by purchase or offset or otherwise, to their detriment;

v) abuse relating to customer orders;

vi) "wash trades", involving no change of beneficial ownership or economic purpose;

vii) collusive trades, which seek improperly to avoid exposure to the pricing mechanism of the market;

viii) violation of applicable position limits;

ix) concealment of a position holder's identity and,

x) misuse of information.

Market Authorities should make clear to market participants what constitutes manipulative, abusive conduct or other prohibited conduct. Market Authorities should have a compliance program that is structured to detect, deter and refer for enforcement action any prohibited conduct.

The reference to "misuse of information" is not intended to imply the application to listed commodity derivatives of insider trading principles that have been developed for securities. Regarding commodity derivatives, the focus in many jurisdictions has been on preventing the disclosure of information by exchange officials and government employees with access to certain information generated by virtue of their positions that is normally expected to remain confidential. Accordingly, misuse of information policies should take into account the functional differences between, and the relevant jurisdiction's statutory treatment of, securities and commodity derivatives.[85]

Discussion

The difference between aggressive trading and manipulation is a fine line: sometimes it may be necessary for supervisors to exercise subjective judgment in deciding whether a particular activity or behavior is detrimental to the majority of the market participants.

Because of this need to exercise subjective judgment, and in order to permit flexibility in preventing novel approaches to market abuses, some Market Authorities might specify those activities which may impair fair and orderly markets; including examples of such activities, or their effects, which they consider relevant to assess manipulative or abusive conduct and to have in place specific rules which prohibit such actions.[86] Market Authorities should also

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85 For example, pursuant to Article 161 or 176 of the Commodity Derivatives Act in Japan, an officer or an employee of a Commodity Exchange or a Commodity Clearing Organization shall not divulge any confidential information he/she has learned during the course of his/her duties. Any person who violates this provision is liable to imprisonment of not more than one year or a fine of not more than five hundred thousand yen, under Article 366 of the CDA.

In the United States, prior to Dodd-Frank legislation, the Insider Trading provisions in Commodity Exchange Act (CEA) Section 9(c)-(d) prohibited employees of CFTC, SROs and markets regulated by CFTC from trading on or delivering to third parties non-public information generated from those entities. Section 746 Dodd-Frank legislation broadened the scope of prohibited conduct to include, among other things, "knowing use" by third parties who receive information imparted by any employee or agent of the federal government and knowingly use such information to enter into or offer to enter into a contract of sale of a commodity for future delivery, an option or a swap.

In the EU, the Market Abuse Directive contains the following definition of inside information for commodity derivatives that is applicable to all persons: "In relation to derivatives on commodities, 'inside information' shall mean information of a precise nature which has not been made public, relating, directly or indirectly, to one or more such derivatives and which users of markets on which such derivatives are traded would expect to receive in accordance with accepted market practices on those markets."

86 Public comment in response to the CFTC's advanced notice of proposed rulemaking on "disruptive practices" emphasized the need to provide clarity with respect to enumerated trading violations and to

make clear that the fact that a particular practice is not explicitly stated does not limit a Market Authority from determining that the practice is manipulative or abusive.

To ensure compliance with these rules, each authority should have in place mechanisms to identify instances of non-compliance and a range of possible sanctions which act as an effective deterrent.

> **Principle: Framework for Addressing Multi-Market Abusive Trading -** *The overall framework for market surveillance and enforcement within a jurisdiction should be structured to provide for active and coordinated detection and enforcement action against manipulative or abusive schemes that might affect trading on multiple exchange and OTC markets, as well as the underlying physical commodity markets.*

Dealing with multi-market abusive trading schemes might involve the inter-play among some combination of Market Authorities (e.g., a futures market, a governmental regulator, an SRO, and physical market regulators) as well as civil or criminal authorities. Although there might be a division of responsibilities in a jurisdiction within and among regulatory agencies, markets and SROs, it is critical that a *coordinated* surveillance and enforcement effort be constructed that has sufficient resources and engages *actively* in a continuous effort to identify and take action against multimarket schemes. This will require the coordinated involvement of at least one Market Authority that has the necessary governmental powers to investigate and take enforcement action against such multi-market schemes.

Discussion

Regulatory experience illustrates that a jurisdiction's surveillance and enforcement structure must be directed to detect and respond to increasingly sophisticated abusive or manipulative trading schemes that involve conduct extending beyond a particular futures exchange. For example, such schemes have involved the attempted manipulation of the physical market to affect the futures market,[87] and the submission of false trades to a price reporting agency in

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avoid vagueness. See proposed *Interpretative Order* at 76 Federal Register 14943 (March 18, 2011). http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-6398a.pdf.

87 In 2008, the CFTC announced that the Dairy Farmers of America, Inc. (DFA), its former Chief Executive Officer and its former Chief Financial Officer wouldl pay a $12 million civil monetary penalty for attempting to manipulate the Class III milk futures contract and exceeding speculative position limits in that contract. The Commission's DFA order finds that, from May 21 through June 23, 2004, the defendants attempted to manipulate the price of the Chicago Mercantile Exchange's (CME) June, July, and August 2004 Class III milk futures contracts through purchases of block cheddar cheese on the CME Cheese Spot Call market. The order finds that the pricing relationship between the CME block cheese market and the Class III milk futures market is well known throughout the industry, and the CME block cheese market price plays a significant part in establishing Class III milk futures prices. http://www.cftc.gov/PressRoom/PressReleases/pr5584-08.html.

In 2008 the CFTC obtained a $10 million civil monetary penalty in a consent order settling charges against *Energy Transfer Partners, L.P.*, of Dallas, Texas, and three ETP subsidiaries: *Energy Transfer Company*, of San Antonio and Houston; *Houston Pipeline Company*, of Houston; and *ETC Marketing, Ltd.*, located in San Antonio and Houston. The defendants were charged with attempting to manipulate natural gas prices at the Houston Ship Channel (HSC) delivery hub. The CFTC's complaint alleged that from September 2005 to early December 2005, the defendants (1) attempted to manipulate the price of natural gas for delivery at the HSC by selling on the Intercontinental Exchange (ICE) massive quantities of natural gas at HSC to place downward pressure on natural gas prices at HSC; and (2) by reporting those transactions to *Inside FERC Gas Market Reports* (Inside FERC), attempted to manipulate the index price of natural gas at HSC that was calculated and disseminated by *Inside FERC*

an attempt to manipulate energy price indexes and benefit positions on a futures exchange.[88] These cases illustrate the importance of a jurisdiction's surveillance and enforcement structure for futures markets taking account of the possibility of manipulations taking place on physical commodity and OTC markets as part of a scheme to influence the futures markets.

> **Principle: Powers and Capacity to Respond to Market Abuse -** *Market Authorities should have adequate powers and capacity to investigate and prosecute actual or suspected market abuse, including attempted manipulation. IOSCO members that are responsible for the oversight of commodity derivatives markets should have all of the powers required by the IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (MMOU).*[89]

Market Authorities should have adequate enforcement powers and capacity to deal with abusive practices on their regulated markets. Such powers should include:

i) investigative and compulsory powers to obtain documents and information (including proprietary systems and software), take statements and/or question persons involved in suspected market abuse. These powers may be shared between authorities (where, for instance, an exchange has investigative powers against its members and wider

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in its October and December 2005 monthly subscriptions. The complaint further alleged that the defendants engaged in this scheme in an attempt to benefit their financial basis swap positions tied to the *Inside FERC* October and December 2005 HSC natural gas index prices. The vast majority of the physical HSC natural gas transactions and the financial basis swaps at issue in the complaint were executed on The ICE. http://www.cftc.gov/PressRoom/PressReleases/pr5471-08.html.

See also *CFTC vs. Parnon Energy Inc., Arcadia Energy (Suisse) SA*, May 2011, in which the CFTC alleges a cross-market trading scheme involving the accumulation and sell-off of a substantial position in physical crude oil to manipulate futures prices. Available at http://www.cftc.gov/PressRoom/PressReleases/pr6041-11.html

88 In 2006 the CFTC entered in to separate consent orders (orders) with defendants Christopher McDonald of Atlanta, Georgia, a former V.P. of West Trading at Mirant Americas Energy Marketing, L.P. and Michael Whalen, a former trader at Cinergy Corporation of Houston, Texas, settling charges that defendants falsely reported and attempted to manipulate natural gas prices. The orders arose from a CFTC lawsuit filed in 2005, charging that between January 2000 and late 2000 or early 2001, defendants repeatedly submitted, and directed others to submit, false natural gas trading information, including fabricated price, volume and counterparty information, to certain firms that compile natural gas price indexes.

See *U.S. Commodity Futures Trading Commission Launches Multiple Federal Actions Against A Total Of 15 Energy Traders, Charging Them With False Reporting And Attempted Manipulation* CFTC Press Release 5045, February 1, 2005, available at http://www.cftc.gov/opa/enf05/opa5045-05.htm. The CFTC complaint charged that during the summer and fall of 2000, Whalen, in concert with McDonald and another Mirant trader named in the complaint, submitted false natural gas trading information to a natural gas price index. The complaint further charged that McDonald, Whalen and their co-defendant knowingly submitted, and worked actively in concert to submit, the false natural gas trade information to companies that calculated natural gas price indexes including *Inside FERC Gas Market Report*, *Gas Daily*, and *Natural Gas Intelligence*, in an attempt to skew that index at multiple natural gas delivery locations to benefit their trading positions. http://www.cftc.gov/PressRoom/PressReleases/pr5258-06.html.

89 See *Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information*, Report of the Executive Committee of IOSCO, May 2002, available at http://www.iosco.org/library/pubdocs/pdf/ioscopd126.pdf.

investigative powers are remitted to a government body, including a public prosecutor or the courts or where needed information concerning a related underlying market is available to another Market Authority);

ii) the power to intervene or direct others to intervene in the market;

iii) the power to take disciplinary action against members and non-members; and

iv) the power to initiate or to refer appropriate matters for criminal prosecution;

Market Authorities should have rules and compliance programs in place to prevent or to deter abusive practices on their markets, including manipulation or attempted manipulation of the market. The rules and compliance programs should take account of the whole position of the market participant. Market Authorities should review their powers on a regular and ongoing basis 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 market participants, including individuals and entities.

Discussion

The harmful market effects of manipulation and the lack of effective means to address manipulative activity has been a longstanding concern of IOSCO,[90] which has stressed that regulators must 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 has identified a number of issues that complicate the successful identification and prosecution of manipulation and other abusive conduct in commodity derivatives markets. These issues can include:

- inadequate legal framework (e.g., poor definitions of prohibited conduct and unrealistic 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 individuals and entities;
- inadequate resources; and
- outdated record-keeping requirements.

Where appropriate, Market Authorities should review their existing statutory and administrative market abuse authority to address these identified issues and to determine

[90] *Investigating and Prosecuting Market Manipulation*, Report of the Technical Committee of IOSCO, May 2000, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD103.pdf.

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 or otherwise engage in manipulative activity and it may be difficult for regulators to prove perfected manipulation. Market Authorities should take affirmative steps to request the necessary powers to enforce against attempted manipulation.[91]

Attempts to manipulate commodity futures markets may often involve conduct in financial and underlying markets. The inability of Market Authorities to access information with regard to certain markets is a material deficiency that should be addressed through legislative action. Market Authorities 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.[92]

In some jurisdictions, Market Authorities do not have the ability to investigate entities that are not licensed or otherwise regulated. This can dampen the ability to investigate and sanction manipulative or abusive conduct. Market Authorities should consider requesting authority to investigate any market participant for potential manipulative or abusive conduct.

Market Authorities 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 physical) commodity markets. This ordinarily will require coordination by a Market Authority that can exercise governmental powers to investigate and take enforcement action.[93]

Market Authorities may wish to consider whether enhancing record keeping requirements, such as telephone recording, Instant Messaging and extended record retention periods could be of benefit to the investigative and enforcement processes.

Powers over Market Members and Non-Members

> **Principle: Disciplinary Sanctions Against Market Members -** *The relevant Market Authority should have and use effective powers to discipline its members or other authorized market participants if an abusive practice has occurred in the market. There should be clarity as to the types of disciplinary actions which can be taken.*
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> *Sanctions should, amongst other things, include some or all of the following measures:*
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> *i) warnings (public and private);*
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> *ii) reprimands;*
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> *iii) re-training;*
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> *iv) restitution;*

91 See *Task Force on Commodity Futures Markets*, Final Report, IOSCO, March 2009, fn 6.

92 Ibid.

93 Ibid.

v) disgorgement of illicit gains;

vi) fines;

vii) conditions on trading;

viii) trading prohibitions;

ix) suspension from membership;

x) expulsion from membership; and

xi) where appropriate, a criminal referral.

Principle: Disciplinary Sanctions Against Non-Members of the Market

The relevant Market Authority should have power to take action against non-members of regulated commodity derivatives markets or other market participants if they have engaged in abusive or manipulative practices, or are suspected of doing so. Market authorities may require contractual relationships between members and customers that enable action to be taken. It is anticipated that enforcement powers will usually be embedded in statute and would be exercised by a government body, including a public prosecutor or the courts.

In addition, Market Authorities should be able to intervene, or cause the exchange to intervene, in the market to address or to prevent an abuse by non-members, using appropriate measures - through members - such as for example by raising the level of margin, imposing trading limits and liquidating positions, as well as removing trading privileges. Any intervention action should be timely.

Markets may not have the authority and, therefore, lack the ability, to take disciplinary actions against non-members. T his may be the case where members' customers trade directly under direct electronic access arrangements. This is because most markets' electronic systems do not identify the particular customers of market-members who may offer sponsored access or automated order routing.[94] The lack of a contractual arrangement between the market and such a market participant also complicates a Market Authority's ability to sanction that participant directly.

Although market rules might make market members responsible for their customers' trading (e.g., "know your customer" rules), there may be legal impediments to prosecute a member for the violation of the market rules caused by its customer. Many markets require members to establish contractual relationships with their customers that include a specification of legal liability for violation of market rules. The Technical Committee has stated that it should be left to individual jurisdictions to determine whether they should establish requirements governing the legal relationships between markets, intermediaries and their customers.[95]

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94 See *Principles for Direct Electronic Access to Markets*, IOSCO August 2010, fn 69.

95 See Ibid Principle 2 "legally binding agreement."

Principle: Information Sharing - *Market Authorities should cooperate with one another, both domestically and outside the jurisdiction, to share information for surveillance and disciplinary purposes. In particular Market Authorities should have arrangements that allow them to share information on large exposures in linked markets and on supplies relative to these markets. These arrangements should take account of (as applicable):*

i) The Exchange International Information Sharing Memorandum of Understanding and Agreement (Exchange International MOU)[96] and the Declaration on Cooperation and Supervision of International Futures Exchanges and Clearing Organizations (Declaration),[97] which facilitate the identification of large exposures by firms that could have a potentially adverse effect on multiple markets;

ii) The IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (MMOU); and

iii) Guidance issued by IOSCO in respect of information sharing, such as IOSCO's Principles Regarding Cross-Border Supervisory Cooperation,[98] Report on Multi-jurisdictional Information Sharing for Market Oversight,[99] and Guidance on Information Sharing.[100]

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96 The development of the *Exchange International MOU* was one of the achievements that resulted from the FIA sponsored Global Task Force on Financial Integrity, which was convened to address the cross-border issues that were identified in connection with the failure of Barings Plc.

97 The *Declaration* was developed through discussions at the CFTC's international regulators conference, and was motivated by work recommendations issued from the Windsor Conference and Tokyo Conference, which were convened by the CFTC, the U.K. FSA and Japanese regulators (Ministry of International Trade and Industry (MITI) and the Ministry of Agriculture, Forestry and Fisheries (MAFF)) to respond to the cross-border issues raised by the failure of Barings Plc. The *Declaration* was developed to address instances in which an exchange would not be able to share information directly with another exchange under the *Exchange International MOU.*

98 See *Principles Regarding Cross-Border Supervisory Cooperation*, Final Report of the Technical Committee of IOSCO, May 2010, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD322.pdf.

99 See p.11 *Multi-jurisdictional Information Sharing for Market Oversight*, Final Report of the Technical Committee of IOSCO, April 2007, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD248.pdf 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 and details of related warehouse information.

100 *Guidance on Information Sharing* (IOSCO 1997) – Internal Document. 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 physical market instrument or physical commodity, procedures for delivery or cash settlement, and deliverable supply of the relevant physical market instrument or physical commodity.

See also *Principles of Memoranda of Understanding*, Report of the Technical Committee of IOSCO, September 1991, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD17.pdf

Information sharing to facilitate heightened surveillance is warranted where physical commodity derivatives contracts trade on different exchanges and are linked economically, such as where one contract's settlement price is determined by reference to the settlement price of the other contract.

When exchange member firms and market participants trade on multiple markets, no one regulator or Market Authority will have all of the information necessary to evaluate the risks to its markets. Accordingly, Market Authorities must be prepared and legally empowered to share such information with their regulatory counterparts, both domestic and foreign, in a timely manner.

Market Authorities should keep confidential requests for information and details of information exchanged. Market Authorities should use no less care in handling information received from another regulator than they would employ to protect the confidentiality of equivalent domestic information. The passing of non-public information by a requesting Market Authority to another Market Authority may be conditioned on the requested authority being satisfied as to the obligation of the requesting authority to maintain an equivalent level of confidentiality and meet other regulatory requirements.

Information shared between Market Authorities should be used solely for carrying out the supervisory responsibilities of the requesting Market Authority, which includes enforcement. A request for information should indicate precisely the reason for the request. Such information should not be used contrary to conditions relating to the use of that information stipulated by the requested Market Authority to give effect to laws, rules or regulations in force in the requested authority's jurisdiction.

Market authorities may need to request changes to legislation and/or rules so that they have the mandate to share information with their regulatory counterparts as outlined.

Discussion

Cooperation is vital to ensuring that investigations and enforcement actions are not impeded unnecessarily by jurisdictional boundaries, both domestic and foreign. The IOSCO Objectives and Principles of Securities Regulation and related Assessment Methodology should be consulted to understand the specific powers that regulators should have for cooperation purposes and the specific expectations that result from those Principles on Cooperation.[101] While regulators have different supervisory approaches, each has a common

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Mechanisms to Enhance Open and Timely Communication Between Market Authorities of Related Cash and Derivative Markets During Periods of Market Disruption, Report of the Technical Committee of IOSCO, October 1993, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD29.pdf.

Report on Cooperation Between Market Authorities and Default Procedures, Report of the Technical Committee of IOSCO, March 1996 available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD49.pdf.

[101] IOSCO Principle 13 measures the extent of a regulator's ability to share information. Principle 14 deals with whether the regulator has mechanisms in place to establish when and how the regulator will share information with its counterparts. Principle 15 relates to the types of assistance that a regulator may provide to a counterpart. The IOSCO Multilateral memorandum of Understanding is designed to

interest in information-sharing and cooperation based on earned trust in each other's regulatory and supervisory systems.[102]

Joint investigations can be complex because they involve regulators from multiple jurisdictions with differing laws and investigative approaches. Where more than one regulator, either within a particular jurisdiction or in different jurisdictions, investigates or acts on the same or a closely related set of market facts, all authorities should seek to co-operate consistent with the IOSCO Principles on Cooperation and other Technical Committee guidance.[103]

The form and content of the cooperation will vary from case to case.[104] It is essential that assistance can be provided not only for use in investigations but also for other types of inquiries, for example as part of a compliance program for the purpose of preventing illicit activities within the scope of commodity derivatives markets regulation or to assist in sharing enforcement techniques between regulators.

Information sharing also is critical to support a Market Authority's market surveillance responsibilities. In this regard, the IOSCO Technical Committee published a report *Guidance on Information Sharing*, which identifies information that may be relevant from a market surveillance perspective in addressing specific types of market events. The type of information that potentially may be relevant for market oversight purposes was further developed in the Technical Committee's report on *Multi-jurisdictional Information Sharing for Market Oversight* published in April 2007.

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 for Market Oversight* report makes clear that parallel trading of derivatives may present opportunities for market participants to engage in conduct that is illegal in one or both jurisdictions. Depending on the links between specific commodity markets, this is an area in which the development of formal information sharing arrangements is appropriate.[105]

Market Authorities should be prepared to share the following types of information with other Market Authorities on a routine basis, as requested:

i) terms and conditions of each commodity derivatives contract, including details of market regulations such as position limits and price limits;

ii) details of delivery rules and procedures;

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facilitate, among other things, the implementation of Principles 13, 14 and 15.

102 See *Principles Regarding Cross-Border Supervisory Cooperation*, IOSCO, May 2010, fn 98.

103 See in particular the Technical Committee's Report *"Joint Cross-Border Investigations and Related Proceedings"*, Internal Report of the Technical Committee of IOSCO, February 2009. This report provides guidance with respect to some of the issues that regulators should anticipate when contemplating a joint investigation.

104 See *Multijurisdictional information sharing and market oversight*, IOSCO, April 2007, fn 99.

105 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. That matter involved futures contracts on ICE Futures Europe that settled off of the price of contracts traded on NYMEX. Available at http://www.fsa.gov.uk/pubs/mou/cftc.pdf.

iii) general details about the range of market information collected and analyzed;

iv) details of designated warehouses and shipping locations; and

v) important contact names in each market.

When a specific concern exists about a potential abuse affecting a market, information-sharing arrangements between Market Authorities should allow Market Authorities to provide the following additional information, as appropriate, to Market Authorities in related markets, whether domestic or outside the jurisdiction, promptly and comprehensively:

i) details of members' positions, in particular details of large positions held by members of and participants in the market, including on-exchange, related OTC derivatives and physical market positions;

ii) inventory levels and locations of delivery stocks;

iii) action taken to implement position management powers;

iv) changes to position limits;

v) additional margin calls; and

vi) other action taken by any relevant Market Authority.

Finally, Market Authorities should recognize the burdens and costs imposed on the requested entity. Information sharing requests can result in information overload and unnecessary burdens, for both the requesting and requested entity, if not carefully calibrated. In this regard, the IOSCO Technical Committee previously has stated:

> *"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. So it is important that authorities likely to require information give thought to the focus, clarity and prioritization of their information requests. They should also be mindful of the types of public information that they can readily obtain from themselves, in particular via websites."*[106]

[106] See p7 *Multi-jurisdictional Information Sharing for Market Oversight*, IOSCO, April 2007, fn 99.

Chapter 7 Principles for Enhancing Price Discovery on Commodity Derivatives Markets

A. Introduction

Commodity futures markets are *price discovery* markets,[107] in which the futures price tracks the prices of, and signals information and expectations about, the direction of the underlying market.[108] It follows that enhancing the availability and quality of information regarding the production, consumption, storage and trading of the *physical commodities* that underlie a financial market contract (i.e., physical commodity market transparency) will improve the reliability of price discovery *in the financial markets* (i.e., futures and OTC derivatives markets).

Transparency with respect to transactions on the financial commodity markets – futures and OTC – is also critical, not only for signaling expectations about price, but also for providing data that might improve the analysis of any causal relationships between financial and physical market activity. The latter objective has taken on increasing political urgency as a result of global concerns with respect to price increases in oil and questions as to whether the "financialization" of commodity markets has systematically pushed prices away from fundamentals or otherwise destabilized prices.

B. Principles

> **Principle: Commodity Derivatives Market Transparency.** *Market Authorities should publish the aggregate exposures of different classes of large traders, especially commercial and non-commercial participants, within the bounds of maintaining trader confidence.*

Discussion

Enhancing transparency to the public through publication of aggregated large trader information

In order to address this need for greater transparency of exchange-traded instruments, the IOSCO Task Force previously endorsed the reporting to Market Authorities of large trader positions for relevant on-exchange contracts and the publication of aggregate data on these

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107 See *The Need for Transparency in Commodity and Commodity Derivatives Markets*, Piero Cinquegrana, European Capital Markets Institute (ECMI), 2008, available at http://www.isn.ethz.ch/isn/Digital-Library/Publications/Detail/?ots591=0c54e3b3-1e9c-be1e-2c24-a6a8c7060233&lng=en&id=94947, at p.17 *et al* for a discussion of the social utility of futures markets price 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."*

108 As noted in *Oil Prices: the True Role of Speculation*, Noël Amenc, Benoît Maffei and Hilary Till, EDHEC Risk and Asset Management Research Centre, November 2008, available at http://www.edhec-risk.com/features/RISKArticle.2008-11-26.0035/attachments/EDHEC%20Position%20Paper%20Oil%20Prices%20and%20Speculation.pdf, 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… ".

positions similar to the weekly Commitment of Traders (COT) reports published by the US CFTC[109] and also published in other jurisdictions.[110]

Publication of aggregate position data to the public has been endorsed in a "technical advice" paper by the Committee of European Securities Regulators (CESR), which recommended that position data reported to Market Authorities regulators "could be used to underpin a system of aggregate open interest reporting to the market, similar to the CFTC's Commitment of Trader's reports."[111]

The COT reports published by the CFTC are available in both a short and long format. The short report shows open interest separately by reportable and non-reportable positions. For reportable positions, additional data is provided for commercial and non-commercial holdings, spreading, changes from the previous report, and percentages of open interest by category, and numbers of traders. Supplemental reports show aggregate futures and options positions on Noncommercial, Commercial, and Index traders in 12 selected agricultural commodities.[112]

A 2006 review of the COT program by the CFTC illustrates both the popularity of the COT reports as well as the types of persons who use the reports.[113] Commenters to this review were virtually unanimous in strongly recommending that the CFTC continue to publish the COT reports.[114] The CFTC's review, which resulted in separate reporting of commodity index reporting, illustrates the need to reexamine markets as they evolve with new types of

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109 See p7 *OR01/11 Task Force on Commodity Futures Markets Report to the Financial Stability Board*, IOSCO, April 2011, fn 7 and p15 *OR08/10 Task Force on Commodity Futures Markets Report to the G-20*, IOSCO, November 2010, fn 7.

110 In the United Kingdom, ICE Futures Europe, publishes Commitment of Trader Reports for its most liquid contracts. See https://www.theice.com/marketdata/reports/ReportCenter.shtml. LIFFE has also announced that it will publish Commitment of Trader Reports for commodity derivatives contracts. In Japan, the Ministry of Economy, Trade and Industry (METI) approved exchange, Tokyo Commodity Exchange, Inc. (TOCOM), publishes the daily Commitment of Trader Reports for all the listed contracts. See http://www.tocom.or.jp/souba/torikumi/index.html for 7 categories, and http://www.tocom.or.jp/souba/torikumi2/index.html for 2 categories.

In Japan, the Ministry of Agriculture, Forestry and Fisheries (MAFF) recognized exchange, Tokyo Grain Exchange, Inc. (TGE), publishes the daily Commitment of Trader Reports for all the listed contracts. See http://www.tge.or.jp/english/trading/kumi_7.shtml and http://www.tge.or.jp/english/trading/kumi_2.shtml.

111 *CESR Technical Advice to the European Commission in the Context of the MIFID Review – Post Trade Transparency Standards*, p. 56, 13 October 2010, available at http://www.esma.europa.eu/popup2.php?id=7284.

112 See CFTC COT link at: http://www.cftc.gov/MarketReports/CommitmentsofTraders/index.htm.

113 One commenter provided a comprehensive list of traders who use the COTs: *"farm marketing advisors/brokers; commercial hedging advisors/brokers; FCMs, IBs, and CTAs; cash merchandiser/hedgers or similar decision makers, including end-users, exporters, processors, merchants; [and] OTC dealers or other trading desks."* Other commenters cited one or more of the types of entities subsumed in the NGFA list. In addition to such commercial and professional users, as noted above, a great many individual traders commented that they depend on the COT reports in conducting their personal trading. See *Commodity Futures Trading Commission Actions in Response to the "Comprehensive Review of the Commitments of Traders Reporting Progra"*, p. 5 (June 21, 2006) http://www.cftc.gov/ucm/groups/public/@commitmentsoftraders/documents/file/noticeonsupplementalcotrept.pdf.

114 Ibid., p.4.

participants.[115]

Publishing position data -- in aggregate to protect strategies and identities of traders - , classified by trader type, provides valuable transparency to market participants and facilitates analysis of market trends and historical development. The dissemination of such market data also aids independent academic research. In order to facilitate "whole market" comparisons and contrasts of markets, global Market Authorities should consider the utility and feasibility of harmonizing public reporting classifications in order to achieve generally comparable data sets (e.g., comparable to the CFTC's COT reports).

> **Principle: OTC transparency –** IOSCO Members **s***hould promote the reporting of OTC derivatives contracts to trade repositories in order to improve transparency, mitigate systemic risk, and protect against market abuse in commodity derivatives markets*[116]*. The relevant governmental regulator of commodity derivatives markets should work with regulators responsible for trade repositories (1) evaluate what improvements are appropriate to enhance the usefulness of, and access by regulators to and disclosure to the public of, OTC commodity derivatives market data that is reported to trade repositories and (2) take affirmative steps such as encouraging ongoing work by the industry, rulemaking or recommending legislative changes to achieve these objectives.*

Discussion

Task Force members are in various stages of contemplating the development, developing or implementing OTC derivatives market reforms. These efforts, which have been called for by the G20, will improve the transparency and oversight of the OTC derivatives markets. They include measures to increase the percentage of transactions which are executed on electronic platforms, and to provide for the reporting of transactions to trade repositories and the

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115 The CFTC explained its reasoning for publishing a new category for index traders as follows: *Historically, the intent of the classification of traders in the COT reports is to class traders according to their general purpose for trading in futures markets. In the past, and for many markets currently, a two-fold classification of reportable traders as "non-commercial" and "commercial" was, and is, appropriate. The activity of these two classes of traders is seen to convey information about market conditions in the underlying physical market.*

In contrast, commodity index trading, whose purpose is to gain long-side exposure to a broad index of commodity prices as an asset class, is not based on a view about current or expected individual commodity prices, as would be the case for most speculative trading. It is not based on, nor does it convey any information about, activity in the underlying [physical market], as would be the case for most traditional hedging activity. Accordingly, the Commission believes the COT reports would be enhanced, and market transparency improved, if commodity index trading were separately reported, provided that such separation can be done accurately. See "*Commodity Futures Trading Commission Actions in Response to the "Comprehensive Review of the Commitments of Traders Reporting Program,*" p.9 (June 21, 2006) http://www.cftc.gov/ucm/groups/public/@commitmentsoftraders/documents/file/noticeonsupplementalcotrept.pdf.

116 Data collected in trade repositories may assist Market Authorities in conducting a range of activities, including in systemic risk monitoring, prudential supervision and combating market abuse. The introduction of the repositories is part of a package of measures, including revised capital treatment, trading and clearing arrangements designed to mitigate/ achieve the risks/objectives identified by G20, which include systemic risk, transparency and market abuse.

disclosure of appropriate information to the public.[117]

The use of trade repositories significantly increases the transparency of derivative transactions because they create a central location where all relevant regulators evaluate the market for systemic risk issues. This is especially true for non-standardized, illiquid transactions that may not be subject to clearing requirements. Additionally, trade repositories also help relevant national regulators by supplying data that could be helpful in pursuing manipulation cases that have been committed across multiple global financial markets.[118]

However, the Task Force acknowledges that OTC markets are global and effective reform cannot be accomplished by any nation or limited group of nations. If jurisdictions do not adopt similar reforms or adopt less stringent requirements it could inadvertently act as an incentive for counterparties to transact in a less regulated jurisdiction. It is also critical that the implementation of the OTC derivatives markets reforms be based on international harmonization and cooperation that avoids overlapping and potentially conflicting sets of regulation for entities operating on a global basis.

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117 The Pittsburgh Leader's Statement (September 24-25, 2009) provided in part that: "All standardized OTC derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties. OTC derivatives contracts should be reported to trade repositories", available at http://www.G20.org/Documents/pittsburgh_summit_leaders_statement_250909.pdf.

118 See p12 *OR08/10 Task Force on Commodity Futures Markets Report to the G-20*, IOSCO, November 2010, fn 7

Chapter 8 Conclusion

Market Authorities play a key role in ensuring that physical commodity markets operate free from manipulation and abusive trading. Market Authorities also play a critical role in responding effectively to disorderly market conditions. The Principles set out in this Report will assist Market Authorities in constructing an appropriate regulatory and supervisory approach that meets these objectives. Accordingly, Market Authorities should review their policies and seek to ensure that these Principles are put into effect.

These Principles will be of little effect in the absence of a commitment to implementing in fact a robust and active surveillance and enforcement structure. However, the focus of such a structure cannot be one dimensional and focused solely on an individual exchange, although such surveillance remains essential.

The occurrence of multi-market trading abuses which have involved commodity futures, OTC derivatives and physical commodity markets, requires that there be a Market Authority in the IOSCO Member's jurisdiction charged with the responsibility to actively conduct surveillance and enforcement to detect and prosecute such abusive schemes. Although no Market Authority can prevent every market abuse, credible efforts are necessary.

This report emphasizes the key importance of transparency as a means of improving market functioning and understanding. The improvements in transparency called for are intended to improve stakeholder confidence and visibility to regulators. If a market were to have better information on which to base its decisions, the dividend would be a substantial improvement in market functioning. This is true not only for information about commodity derivatives, but also for information about the underlying markets, both data on market fundamentals and data on physical trades.

This Report makes clear that understanding prices in the physical commodity markets is an important element for understanding price formation in the commodity derivatives markets. This is an area that deserves continued analysis by suitable organizations with a focus on physical commodity markets.

Appendix A Summary of the Principles (without footnote citations)

Contract Design Principles

- **Principle: Accountability** – *Market Authorities should establish a clear framework as to design and review criteria or procedures for commodity derivatives contracts. Market Authorities should be accountable for compliance with statutory and/or self-regulatory standards on a continuing basis and should retain powers to address the provisions of existing contracts which produce manipulative or disorderly conditions. At a minimum a statutory Market Authority should have legal powers to address and where necessary to vary contract provisions which produce, or are deemed likely to produce, manipulative or disorderly conditions.*

- **Principle: Economic Utility** - *Contracts should meet the risk management needs of potential users and promote price discovery of the underlying commodity.*

  The design and/or review of commodity derivatives contracts should include a determination that the contract can meet the risk management needs of potential users of the contract and/or promote price discovery of the underlying commodity. The determination of economic utility may be supported by surveys of potential contract users or may be implied - for example, from an analysis of the physical market.

  The regulator should, as a minimum requirement, be informed of the type of products to be traded on an exchange or trading system and should review and/or approve the rules governing the trading of the product.

- **Principle: Correlation with Physical Market** - *Contract terms and conditions generally should, to the extent possible, reflect the operation of (i.e., the trading in) the underlying physical market and avoid impediments to delivery.*

- **Principle: Promotion of Price Convergence through Settlement Reliability** - *Settlement and delivery procedures should reflect the underlying physical market and promote reliable pricing relationships and price convergence and should be regularly evaluated to ensure that they meet this standard. Settlement and delivery terms should be specified and made available to market participants.*

- **Principle: Responsiveness** - *The views of potential contract users should be taken into account in designing commodity contracts.*

- **Principle: Transparency** - *Information concerning a physical commodity derivatives contract's terms and conditions, as well as other relevant information concerning delivery and pricing, should be readily available to Market Authorities with respect to all derivatives transactions within its jurisdiction and to market participants in organized derivatives markets.*

  Without limiting the factors that a Market Authority includes in those terms and conditions, market rules should specify, for example:

  i) Minimum price fluctuations (price ticks);

ii) *Maximum price fluctuations (daily price limits), if any;*

iii) *Last trading day;*

iv) *Settlement and delivery procedures;*

v) *Trading months;*

vi) *Position limits, if any;*

vii) *Reportable levels; and*

viii) *Trading hours.*

Principles for Surveillance of Commodity Derivatives Markets

- **Principle: Framework for Undertaking Market Surveillance** - *Market Authorities should have a clear and robust framework for conducting market surveillance, compliance and enforcement activities and there should be oversight of these activities. A market surveillance program should take account of a trader's related derivatives and physical market positions and transactions. Market surveillance programs should be supported by sufficient resources, access to physical market data and analytical capabilities.*

- **Principle: Monitoring, Collecting and Analyzing Information –** *Market Authorities should develop, employ and maintain methods for monitoring of trading activity on the markets they supervise, collecting needed information and analyzing the information they collect that are efficient and suitable for the type of market being supervised. Effective monitoring of orders and electronic transactions requires real-time monitoring capabilities, supported by automated systems that detect trading anomalies. Monitoring, collection and analysis should also focus on intra-day trading.*

- **Principle: Authority to Access information** - *Market Authorities should have the authority to access information on a routine and non-routine basis for regulated commodity derivatives markets as well as the power to obtain information on a market participant's positions in related over-the-counter (OTC) commodity derivatives and the underlying physical commodity markets. In particular, Market Authorities should have the power to:*

  i) *access information that allows the reconstruction of all transactions on a regulated commodity derivatives market (audit trail);*

  ii) *access information that permits them to identify large positions (i.e., "large exposures" or "concentrations") and the composition of the market in question;*

  iii) *access information, if needed, on the size and beneficial ownership of positions held by a market participant in order to aggregate positions held under common ownership and control;*

iv) *access information about a market participant's transactions and positions in related OTC and physical commodity markets; and*

v) *take appropriate action where a commodity derivatives market participant does not make requested market information available to the Market Authority.*

Market Authorities should review the scope of their authority to obtain such information and if necessary to request such power from the relevant legislature or other appropriate governmental bodies.

- **Principle: Collection of Information on On-Exchange Transactions –** *In respect to on-exchange commodity derivatives transactions, a Market Authority should collect information on a routine and regular basis on:*

  i) *pricing of contracts throughout the trading day in real time;*

  ii) *daily transactional information including time and date of trade, commodity contract, delivery month, expiry date, buy/sell, quantity, counterparties to the contract, and price of the contract;*

  iii) *daily reports of end-of-day positions held by market intermediaries (both "whole firm" and by individual trader) and by other market participants, where the size of the position is above a specified level ("large position"). Information collected should permit a Market Authority to identify each position holder (by name or code) down to the first customer level, and the size of position, by contract month, for each position holder.*

  The Market Authority should have the capability to aggregate position holder information promptly in order to identify positions under common ownership or control;

  iv) *where appropriate, warehouse stocks or other deliverable supply.*

- **Principle: Collection of OTC Information** – *In respect of OTC commodity derivatives transactions and positions, a Market Authority should consider what information it should collect on a routine basis and what it should collect on an "as needed" basis. A Market Authority that has access to a relevant Trade Repository's (TR) data should take such broader access into account, as well as its statutory obligations with respect to the TR, in constructing its data collection policies.*

Information could include, as appropriate:

For *information collected on a routine basis:*

i) *transactional information including time and date of transaction, contract terms and, counterparties to the contract and price of contract; and*
ii) *position information.*

For information collected on an as needed basis

i) delivery intentions;

ii) beneficial owners;

iii) positions under common control; and

iv) for contracts other than forwards, additional information may also need to be sought on notional values, replacement cost, valuation methodology or duration of the contracts.

- **Principle: Large Positions** – *Market Authorities should require the reporting of large trader positions for the relevant on-exchange commodity derivatives contracts. The Market Authority should have the ability to aggregate positions owned by, or beneficially controlled on behalf of, a common owner.*

Principles to Address Disorderly Commodity Derivatives Markets

- **Principle: Intervention Powers in the Market** - *Market Authorities should have, and use, effective powers to intervene in commodity derivatives markets to prevent or address disorderly markets and to ensure the efficiency of the markets. These powers should include the following:*

1) Position Management Powers, Including the Power to Set Position Limits - *Market Authorities should have and use formal position management powers, including the power to set ex-ante position limits, particularly in the delivery month,.*
These should necessarily include position management powers that:

(a) Establish a trader's automatic consent to follow an order of the Market Authority when that trader's position reaches a defined threshold size or any size, which the Market Authority considers prejudicial to orderly market functioning, taking into account all relevant circumstances. They should also require such a trader to comply with the Market Authority's order, either not to increase a position or to decrease a position; and

(b) Authorize a Market Authority to place ex-ante restrictions on the size of a position a market participant can take in a commodity derivatives contract (i.e., position limits).

2) Other Discretionary Powers - *Market Authorities should also have the powers to employ any of the following measures, as appropriate to address market disruption or the perceived threat of such disruption or to assist market surveillance efforts:*

a) the imposition of price movement limits;

b) *calling for additional margin, either from customers or from clearing members on behalf of their clients;*

c) *ordering the liquidation or transfer of open positions;*

d) *suspending or curtailing trading on the market (e.g., trading halts and circuit breakers);*

e) *altering the delivery terms or conditions;*

f) *cancelling trades;*

g) *requiring owners of positions to specify delivery intentions; and*

h) *requiring traders to disclose related OTC derivatives or large physical market positions.*

- **Principle: Review of Evolving Practices** - *Market Authorities should have, or contribute to, a process to review the perimeter of regulation to ensure that they have the power to address evolving trading practices that might result in a disorderly market. Exchanges and self-regulatory organizations play a critical and complementary role with governmental regulators in identifying such practices.*

Principles for Enforcement and Information Sharing

- **Principle: Rules and Compliance Programs** - *Market Authorities should have rules, compliance programs, sanctioning policies and powers to prohibit, detect, prevent and deter abusive practices on their markets, including manipulation or attempted manipulation of the market. The rules and compliance programs should take account of the whole position of the market participant (i.e., all positions under common ownership and control). There should be clarity as to what constitutes manipulative, abusive conduct or other prohibited conduct.*

  Specific practices which Market Authorities should seek to detect and prevent include, among others:

  i) *causing, or attempting to cause, artificial pricing in the market;*

  ii) *creating a false or misleading appearance of active trading;*

  iii) *disseminating false or misleading information in respect of the market or conditions that affect the price of any commodity;*

  iv) *creating, or attempting to create, a corner or squeeze, in which an abusive controlling position is accumulated in the physical and/or futures or OTC markets, forcing those holding short positions to settle their obligations, by purchase or offset or otherwise, to their detriment;*

  v) *abuse relating to customer orders;*

vi) "wash trades", involving no change of beneficial ownership or economic purpose;

vii) collusive trades, which seek improperly to avoid exposure to the pricing mechanism of the market;

viii) violation of applicable position limits;

ix) concealment of a position holder's identity and,

x) misuse of information.

- **Principle: Framework for Addressing Multi-Market Abusive Trading -** *The overall framework for market surveillance and enforcement within a jurisdiction should be structured to provide for active and coordinated detection and enforcement action against manipulative or abusive schemes that might affect trading on multiple exchange and OTC markets, as well as the underlying physical commodity markets.*

- **Principle: Powers and Capacity to Respond to Market Abuse -** *Market Authorities should have adequate powers and capacity to investigate and prosecute actual or suspected market abuse, including attempted manipulation. IOSCO members that are responsible for the oversight of commodity derivatives markets should have all of the powers required by the IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (MMOU).*

- **Principle: Disciplinary Sanctions Against Market Members -** *The relevant Market Authority should have and use effective powers to discipline its members or other authorized market participants if an abusive practice has occurred in the market. There should be clarity as to the types of disciplinary actions which can be taken.*

  Sanctions should, amongst other things, include some or all of the following measures:

  i) warnings (public and private);

  ii) reprimands;

  iii) re-training;

  iv) restitution;

  v) disgorgement of illicit gains

  vi) fines;

  vii) conditions on trading;

  viii) trading prohibitions;

ix) suspension from membership;

x) expulsion from membership; and

xi) *where appropriate, a criminal referral.*

- **Principle: Disciplinary Sanctions Against Non-Members of the Market**
  The relevant Market Authority should have power to take action against non-members of regulated commodity derivatives markets or other market participants if they have engaged in abusive or manipulative practices, or are suspected of doing so. Market authorities may require contractual relationships between members and customers that enable action to be taken. It is anticipated that enforcement powers will usually be embedded in statute and would be exercised by a government body, including a public prosecutor or the courts.

  In addition, Market Authorities should be able to intervene, or cause the exchange to intervene, in the market to address or to prevent an abuse by non-members, using appropriate measures - through members - such as for example by raising the level of margin, imposing trading limits and liquidating positions, as well as removing trading privileges. Any intervention action should be timely.

- **Principle: Information Sharing -** *Market Authorities should cooperate with one another, both domestically and outside the jurisdiction, to share information for surveillance and disciplinary purposes. In particular Market Authorities should have arrangements that allow them to share information on large exposures in linked markets and on supplies relative to these markets. These arrangements should take account of (as applicable):*

  i) The Exchange International Information Sharing Memorandum of Understanding and Agreement (Exchange International MOU) and the Declaration on Cooperation and Supervision of International Futures Exchanges and Clearing Organizations (Declaration), which facilitate the identification of large exposures by firms that could have a potentially adverse effect on multiple markets;

  ii) The IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (MMOU); and

  iii) Guidance issued by IOSCO in respect of information sharing, such as IOSCO's Principles Regarding Cross-Border Supervisory Cooperation, Report on Multi-jurisdictional Information Sharing for Market Oversight, and Guidance on Information Sharing.

  Information sharing to facilitate heightened surveillance is warranted where physical commodity derivatives contracts trade on different exchanges and are linked economically, such as where one contract's settlement price is determined by reference to the settlement price of the other contract.

Principles for Enhancing Price Discovery on Commodity Derivatives Markets

- **Principle: Commodity Derivatives Market Transparency.** *Market Authorities should publish the aggregate exposures of different classes of large traders, especially commercial and non-commercial participants, within the bounds of maintaining trader confidence.*

- **Principle: OTC Transparency –** *IOSCO Members should promote the reporting of OTC derivatives contracts to trade repositories in order to improve transparency, mitigate systemic risk, and protect against market abuse in commodity derivatives markets. The relevant governmental regulator of commodity derivatives markets should work with regulators responsible for trade repositories to:*

    i) evaluate what improvements are appropriate to enhance the usefulness of, and access by regulators to and disclosure to the public of, OTC commodity derivatives market data that is reported to trade repositories; and

    ii) take affirmative steps such as encouraging ongoing work by the industry, rulemaking or recommending legislative changes to achieve these objectives.

Appendix B - Glossary of Terms

Many of the terms contained in this Glossary are either defined by an IOSCO member's regulation or are accepted terminology that has unique meanings, which have developed in a particular jurisdiction's markets. Therefore the definitions that follow are intended to be generally descriptive, providing clarity to the interpretation of this document, but are not intended to be legally authoritative for any jurisdiction or market.

Banging the Close - A manipulative or disruptive trading practice whereby a trader buys or sells a large number of futures contracts during the closing period of a futures contract (i.e., the period during which the futures settlement price is determined) in order to benefit an even **l**arger position in an option, swap, or other derivative that is cash settled based on the futures settlement price on that day.

Commercial Participant – A person who is hedging an underlying physical interest.

Corner - A situation where the rights to receive delivery on expiration of future contracts held by one or a group of participants acting in concert constitutes a substantial proportion of the quantity of underlying commodities eligible for delivery against the contract. This activity can also be referred to using other terms such as "squeeze".

First Customer - For purposes of this Report, the term "first customer" means: the actual person who submitted the trade for execution – (1) either a trader with direct electronic access, with the trade cleared by a clearing firm, in which case the direct access trader is the "first customer" of its clearing firm, (2) an individual client who submits an order through an intermediary for execution, in which case the client is the "first customer" of the intermediary or (3) an intermediary trading for its proprietary account, in which case the intermediary is its clearing firm's first customer.

Futures Contract – An agreement to purchase or sell a commodity for delivery in the future: (1) at a price that is determined at initiation of the contract; (2) that obligates each party to the contract to fulfill the contract at the specified price; (3) that is used to assume or shift price risk; (4) that is cleared through a central counterparty; and (5) that may be satisfied by delivery or cash settlement, or may be offset prior to delivery.

Hedge or Hedging - Conduct that is described as permissible "hedging" activity may differ among jurisdictions. Without limiting the scope of any jurisdiction to adopt its own definition, the term "hedge" or "hedging" generally refers to the taking of a position in a commodity derivative contract opposite to a position held in the physical market to minimize the risk of financial and/or economic loss from an adverse price change, or otherwise for risk management purposes.

For example: The term "hedging" could mean the entering into of a derivatives transaction or a series of derivatives transactions, and the maintaining of the position or positions resulting from the transaction or series of transactions if:

1. the intended effect of the transaction or series of transactions is

a) to offset or reduce the risk related to fluctuations in the value of an underlying interest or a position, or of a group of underlying interests or positions; or

b) to substitute a risk to one currency for a risk to another currency, provided the aggregate amount of currency risk to which the hedger is exposed is not increased by the substitution;

2. the transaction or series of transactions results in a high degree of negative correlation between changes in the value of the underlying interest or position or group of underlying interests or positions being hedged and changes in the value of the derivatives with which the value of the underlying interests or positions is hedged; and

3. there are reasonable grounds to believe that the transaction or series of transactions no more than offsets the effect of price changes in the underlying interest or position, or group of underlying interests or positions, being hedged;

Large Positions - The terms "large positions," "large concentrations "and "large exposures" may be used inter-changeably and refer to an open position that is sufficiently large to be potentially prejudicial to orderly market functioning.

Market Authority- A governmental regulator, a self-regulatory organization or a regulated market.

Non-Commercial Participant – A person who does not hedge an underlying physical position, but who trades with the objective of achieving profits through the anticipation of price movements.

Parallel Trading - Trading in a derivatives contract in one market that is based on the same, or "related" underlying physical commodity of a derivative contract traded by the same market participant on another market.

Physical Commodity- A tangible product or raw material, as opposed to an instrument which references a physical commodity. The term "physical commodity" also can be construed broadly to include electric power or greenhouse gas emission allowances. For convenience, the term "physical commodity" may be referred to as "commodity" throughout the text.

Physical Commodity Derivatives – Derivatives contracts that reference a physical commodity, physical commodity index or price series and which settle in cash or by delivery of the underlying commodity. For example, futures and OTC contracts, and options on such contracts, where the underlying reference interest is a physical commodity. For convenience, physical commodity derivatives may be referred to as "commodity derivatives" throughout the text.

Physical Commodity Derivatives Market - Markets that allow for the execution and/or trading of contracts that reference an underlying physical commodity, whether settled in cash or by delivery of a physical commodity. For convenience, physical commodity

derivatives markets may be referred to as "commodity derivatives markets" throughout the text.

Physical Commodity Market – This refers broadly to any forum where the purchase and sale of physical commodities are transacted. The use of the term "market" in this context should be construed broadly and liberally and does not require the existence of a formal, organized market. Accordingly, a physical market could be:

1. an organized, self-regulated central market;

2. a decentralized over-the-counter market; or

3. a local organization, such as a grain elevator or meat processor, which provides a market for a small region.

For convenience, a "physical commodity market" may be referred to as "commodity market" throughout the text

Price Convergence - A movement in the price of a futures contract toward the price of the underlying cash commodity as the contract approaches expiry.

Price Discovery – The process of determining the price level for a commodity based on supply and demand conditions. Price discovery occurs in both a derivatives market and in the underlying physical market for a particular commodity.

Related Positions, Related Transactions or Related Commodity Market – In general, these terms refer to positions, transactions and markets for physical commodity derivatives or physical commodity markets that are somehow linked or tied economically to the position in the regulated commodity derivatives market.

- Related positions could be deemed to include a futures contract and physical commodity OTC derivatives contract that reference the same commodity; a futures contract that settles off of the price of another futures contract; a futures contract and a physical commodity position for the same commodity; a futures contract and an "economically equivalent" physical commodity contract. The determination of what constitutes a "related position" is left to the discretion of the relevant Market Authority.

Spoofing – Accepted terminology in most jurisdictions that is generally understood as bidding or offering with the intent to cancel such bid or offer before execution.

Spot month - The trading period immediately preceding the delivery period for physically delivered derivatives contracts, cash settled swaps and futures contracts.

- The term "spot month" does not necessarily refer to a calendar month of time. Rather, it is the trading period immediately preceding the delivery/settlement period for physically-delivered futures contracts/cash settled swaps and futures contracts. For example, it may include the delivery period while the futures contract is available for trading (i.e., the contract's last trading day has not occurred but delivery is permissible.) The length of this period may vary

depending upon the contract terms.

Wash trading - Entering into, or purporting to enter into, transactions to give the appearance that purchases and sales have been made, without incurring market risk or changing the trader's market position.

Appendix C

IOSCO Technical Committee Task Force on Commodity Futures Markets

Co-Chairs

Financial Services Authority, United Kingdom	Alexander Justham Director, Markets Division
Commodity Futures Trading Commission, United States	Jacqueline Mesa Director, Office of International Affairs

Members

Australia Securities Investment Commission	Steven Bardy John Krslovic Rhonda Luo
Commissão de Valores Mobiliários, Brazil	Marcos Galileu Lorena Dutra
Alberta Securities Commission, Canada	Debra McIntyre
Ontario Securities Commission, Canada	Kevin Fine
Autorité des marches financiers, Canada – Québec	Derek West Philippe Vallée
China Securities Regulatory Commission,	Peng Junheng Cheng Haibo Li Hui
Dubai Financial Services Authority	Eric Salomons
Autorité des marches financiers, France	Wayne Smith
Bundesanstalt für Finanzdienstleistungsaufsicht, Germany	Stefan Pankoke
Securities and Futures Commission, Hong Kong	Stanley Ng George Tam
Commissione Nazionale per le Società e la Borsa, Italy	Sara Bosio
Financial Services Agency, Japan	Kenji Hoki Yoshiko Nakano

Ministry of Agriculture, Forestry and Fisheries, Japan	Shinya Moriki
Ministry of Economy, Trade and Industry, Japan	Shoko Nakano
Finanstilsynet, Norway	Knut Godager
Monetary Authority of Singapore	Chang Tze Ching Phua Tiak Peow
Capital Markets Authority, Saudi Arabia	Abdullah F. Al-Abduljabbar John Mathias
Financial Market Supervisory Authority (FINMA), Switzerland	Marc Luginbühl Patrick Goebel
Financial Services Authority, United Kingdom	Jonathan Hill Iain Sanders
Commodity Futures Trading Commission, United States	Robert Rosenfeld Aaron Miller
IOSCO General Secretariat	Tajinder Singh Yukako Fujioka