Comments on European Securities and Markets Authority's (ESMA) policy orientations on guidelines for UCITS [Undertaking for Collective Investment in Transferable Securities] Exchange-Traded Funds and Structured UCITS

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September 22, 2011

The Institute for Agriculture and Trade Policy (IATP) is a nonprofit, 501(c)(3) nongovernmental organization, headquartered in Minneapolis, MN with an office in Washington, D.C. Our mission states, "The Institute for Agriculture and Trade Policy works locally and globally at the intersection of policy and practice to ensure fair and sustainable food, farm and trade systems." To carry out this mission, as regards commodity market regulation, IATP has participated in the Commodity Markets Oversight Coalition (CMOC), a network of commercial hedgers and public interest groups, since 2009. IATP has submitted several comments on Commodity Futures Trading Commission (CFTC) rulemaking, and on consultation papers of the International Organization of Securities Commissions and the European Commission's Directorate General for Internal Markets. Some of our recent writing on commodity market regulation is collected in *Excessive Speculation in Agricultural Commodity Markets: Selected Writings 2008-2011.*[i]

General comment

IATP is not among the "asset management companies and trade associations of asset management companies" managing Exchange Traded Funds (ETFs) to whom the ESMA discussion paper is directed. However, we are compelled to comment on the paper because of the damage to commercial hedging and to food and energy security that has been caused by excessive speculation in commodities, whether invested through over-the-counter index funds or through ETFs. There is a wide array of studies that demonstrate the harmful effects of index speculation on transparent price discovery and commodity prices and volatility,[ii] so we will not rebut apologists for excessive speculation here. The United Nations Food and Agriculture Organization (FAO) has identified higher and more volatile prices as a factor in the increase of food insecurity in more than three dozen FAO member states.[iii] There is a statistically compelling argument for spot month and aggregate position limit rules to help prevent excessive speculation.[iv] In responding to some of ESMA's questions, which apply to ETFs across a range of asset classes, our focus will remain on commodity derivatives.

We agree with the view of the Financial Stability Board in its April 2011 note, cited in your discussion paper (p. 5),[v] that the increasing incorporation of commodity derivatives into ETF investment strategies is a "disquieting development."[vi] As FSB notes, "plain-vanilla ETFs" were designed to manage risk in the large universe of equities and not in relatively thinly capitalized markets, such as that of commodity derivatives. The G-20 financial ministers have yet to incorporate this FSB warning into their recommendations on commodity price volatility. We are aware of the transatlantic diplomatic tension regarding European Parliament directives on OTC derivatives, which has apparently resulted from U.S. Secretary of Treasury Timothy Geithner's efforts to persuade the EU presidency to extend G-20 recommendations on OTC derivatives to ETF derivatives.[vii] However, we are grateful that ESMA has taken the initiative to request comments on ETFs, since the weight of money of commodity index products, whether traded OTC or exchange traded, will continue to induce volatility and drive bona fide hedgers from commodity markets, unless those products are tightly regulated and those regulations are enforced.

Hardly a week goes by, it seems, but that another financial firm announces another ETF "innovation" to track another commodity index in the name of portfolio diversification.[viii] While these products are targeted at institutional investors, such as pension funds and university endowments, warnings about the risks of synthetic ETFs for retail investors, such as those indicated in the discussion paper (paragraph 4) should be extended to institutional investors and their retail customers. The sudden and largely correlated fall in commodity prices in mid-May triggered by High Frequency Trading of ETFs[ix] surely caught a majority of ETF institutional investors by surprise. The ongoing lack of regulation of HFT strategies, including the HFT placing of orders with no intention of completing trades ("spoofing"), is further grounds for the restrictions on ETF trading that ESMA is contemplating. IATP regrets that we will not be able to attend ESMA's September 27 public hearing on automated trading, but we look forward to reading the post-hearing report.

Answers to specific questions

Q1: Do you agree that ESMA should explore possible common approaches to the issue of marketing of synthetic ETFs and structured UCITS to retail investors, including potential limitations on the distribution of certain complex products to retail investors? If not, please give reasons.

We strongly agree, but as noted above, we believe that there also should be product warnings for institutional investors too, particularly if HFT and "spoofing" remain unregulated. Ongoing investigations of the effect of HFT on market order and liquidity will produce evidence that can provide ESMA guidance for such warnings and product distribution limitations.[x]

Q2: Do you think that structured UCITS and other UCITS which employ complex portfolio management techniques should be considered as 'complex'? Which criteria could be used to determine which UCITS should be considered as 'complex'?

Yes. UCITS that are traded algorithmically and/or through HFT strategies should be considered complex. Regarding criteria for determining complexity, commodity ETFs and Exchange Traded Notes (ETNs) should be considered complex, particularly when pre-trade data about the physical stocks of the underlying assets in a commodity ETF or ETN are opaque, frequently inaccurate, or incomplete. Mixed swaps of commodity and financial instruments (e.g., "hedging" interest rate volatility with cash flows from a bundle of oil futures contracts) should be considered complex. Derivatives instruments classified by the Bank for International Settlements as "unallocated" should likewise be considered complex, since the trade data reporting that results in such classification is inaccurate, incomplete and/or too tardy to contribute to significant price discovery during the life of the commodity contracts incorporated into the derivative.

Q3: Do you have any specific suggestions on the measures that should be introduced to avoid inappropriate UCITS being bought by retail investors, such as potential limitations on distribution or issuing of warnings?

We do not believe that complex UCITS incorporating commodity contracts or tracking indices should be marketed to retail investors. Most retail investors lack detailed and timely information about the deliverable supply of the underlying assets of commodity ETFs and ETNs, unlike major swaps dealers, most of whom hold large positions in physical commodities, particularly in energy stocks. However, if ESMA decides that retail investors should be exposed to the risks of complex UCITS, we recommend that it design an investment suitability test. The test would require documented confirmation that the retail investor had equal access to HFT terminals as do major swap dealers, was knowledgeable about algorithmic trading strategies, and could post higher margin collateral than would be required for exchange trading of futures and options contracts.

Q5: Are there any issues in terms of systemic risk not yet identified by other international bodies that ESMA should address?

The notional value of commodity derivatives is sometimes considered to be too small to pose systemic risk to major swaps dealers and index investors, even in the case of cascades of counterparty default. IATP is not confident that the at least $2 trillion USD taxpayer-financed recapitalization of U.S. and European Banks in 2008 by the U.S. Federal Reserve Bank and the U.S. Department of Treasury[xi] has made major swaps dealers any more prudent than they were before the legislative and financial rescues of their industry. Indeed, the denial by the International Institute for International Finance (IIF), in its recent report to the Group of 20, that financial institution speculation had <u>any effect</u> on commodity prices and price volatility,[xii] is not only profoundly intellectually flawed but demonstrates why ESMA should not develop technical standards to implement the "light-touch" regulation IIF has advocated before and after the crisis of the fall of 2008. The "clear causal connection" between excessive speculation and commodity price volatility in specific contracts demanded by the IIF report cannot be produced, of course, when regulators have exempted swaps dealers from reporting trade data. For example, among U.S. commercial hedgers of energy derivatives, the swap dealer reporting exemption for energy derivatives was called the "Enron Loophole." However, we believe that as the EU and U.S. develop market surveillance of more complete, timely and accurate trade data reporting, a better assessment of the systemic risk posed by excessive speculation in commodity derivatives will become possible.

IATP believes that ESMA should broaden the definition of systemic risk to include not just the risks posed by the ETF and HFT trading by major swaps dealers but the aggregate risk posed by counterparty default of major swaps participants. If the U.S. and EU end-user exemptions to clearing of OTC derivatives is as broad as that advocated by the International Swaps and Derivatives Association (ISDA), i.e., to cover all financial risk and not just risk of hedged commodities, the risk of end-user counterparty default for commodity swaps and mixed swaps will not be insignificant. In building a framework for evaluating factors of systemic risk pertaining to major swaps dealers and participants, ESMA should consider the volatility in the valuation of underlying assets due to the fragmentary nature of pre-trade commodity data. The U.N. Conference on Trade and Development (UNCTAD) has recently summarized the sources of commodity trade data.[xiii] ESMA should review this study and similar ones to help build its framework for evaluating systemic risk posed by excessive speculation in ETFs and ETNs.

Q7: Do you agree that ESMA should also discuss the above-mentioned issues [regarding the retail marketing of ETNs and Special Purpose Vehicles] with a view to avoiding regulatory gaps that could harm European investors and markets? If not, please give reasons.

In general, IATP believes that prudent regulation requires overlaps and redundancies in order to prevent the structuring of products designed to exploit regulatory gaps. Given the notoriety of Special Purpose Vehicles (SPVs) to "park" debt and misrepresent balance sheet, ESMA should write a consultation paper and hold a hearing on SPVs and ETNs.

Q43: Do you agree with ESMA's policy orientations on strategy indices? If not, please give reasons.

ESMA's discussion of strategy indices is oriented towards financial indices. However, if ESMA expands the discussion of strategy indices to cover commodity derivatives, there will be few, if any, commodity index funds that will trade under UCITS rules. First, ESMA wisely recommends that a financial index be "sufficiently diversified and the price movement of one component does not unduly influence the performance of the index" (paragraph 62). Commodity indices may be weighted as much as 70 percent in one commodity contract, e.g., oil in the Goldman Sachs–S&P index in 2008. Clearly price movements in the oil contract component of such a weighted index will unduly influence its performance. However, even in commodity index funds with more balance among component contracts, price correlations among just two or three underlying assets, e.g., among feed grains, can influence the total return performance of the index.

The necessary transparency measures that ESMA suggests are needed for fund rebalancing and index calculations will not prevent the undue influence of one or even a few commodities on total performance, given the small number of referenced contracts that can be combined in commodity indices. The exposure of retail investors to a retail product in which a "single component [...] represents between 20 and 35 percent of the overall index must disclose this fact in its prospectus and describe the exceptional market conditions which justify this investment" (paragraph 66). In the commodity index world, the index dealer could not appeal to exceptional market conditions to justify the frequency of an index component surpassing the 20 percent threshold. Nor would disclosure of the crossing of the threshold in the prospectus be sufficient warning for a retail investor of the undue influence of one or two commodities on the total performance of the index.

Conclusion

IATP appreciates the opportunity to comment on this and other ESMA discussion papers and consultation documents as it prepares technical standards to advise EU member state authorities on how to implement the revisions of EU derivatives directives. The challenging questions posed by ESMA in this discussion paper were too many and too difficult for IATP to respond to in their entirety. However, as ESMA writes standards to be applied to all asset classes, it should consider the specific challenges that the underlying assets of commodity derivatives pose to the attempt to apply ESMA standards to all asset classes and financial products horizontally.

One final request: Assuming that carbon emissions offset and allowance credits will be regulated as financial instruments in the new legislation, we ask that ESMA hold a public hearing on how market integrity could be affected by problems of environmental integrity of the underlying carbon emissions assets, e.g., the impermanence and leakage of greenhouse gas reductions claimed under offset credits. IATP has responded to the request by the CFTC for comments on the regulation of a carbon emissions derivatives market.[xiv] Since carbon derivatives markets have been proposed as the single largest source for leveraging climate change finance, it is particularly important that ESMA hold at least one public hearing on the market integrity issues posed by regulating carbon emissions offset and allowance credits as financial instruments.

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[i] http://www.iatp.org/files/SpeculationReader.pdf

[ii] See, for example, the bibliography compiled by Markus Henn of WEED at http://www.nefiactioncenter.com/PDF/evidenceonimpactofcommodityspeculation.pdf

[iii] Report of the "Extraordinary Intersessional Group on Grains and the Intergovernmental Group on Rice," Committee on Commodity Problems, UN Food and Agriculture Organization, September 24, 2010.

[iv] See, for example the comment by Better Markets Inc. to the CFTC on its position limits rule. http://www.bettermarkets.com/assets/pdf/CL-CFTC-PL-Final.pdf

[v] http://www.esma.europa.eu/index.php?page=consultation_details&id=187

[vi] http://www.financialstabilityboard.org/publications/r_110412b.pdf

[vii] Jeremy Grant, "European rebuke for US on derivatives," *Financial Times*, June 17, 2011.

[viii] E.g., Chris Flood, "RBS fund taps into commodity trading growth," *Financial Times*, September 12, 2011.

[ix] Jack Farchy, "Nervy investors dump commodities," *Financial Times*, May 7-8, 2011.

[x] E.g., Gregory Meyer, "High-speed commodity traders under crash scrutiny," *Financial Times*, March 10, 2011.

[xi] "Opportunities Exist to Strengthen Policies and Processes to Manage Emergency Assistance," General Accountability Office, July 2011. http://sanders.senate.gov/imo/media/doc/GAO%20Fed%20Investigation.pdf and Bradley Keoun and Phil Kunz, "Wall Street Aristocracy Got $1.2 Trillion in Secret Loans," Bloomberg, August 22, 2011. http://www.bloomberg.com/news/2011-08-21/wall-street-aristocracy-got-1-2-trillion-in-fed-s-secret-loans.html

[xii] "Financial Investment in Commodity Markets: Potential Impact on Commodity Prices and Volatility," International Institute for Finance, September 12, 2011. http://www.iif.com

[xiii] Pilar Fajarnes, "An Overview of Major Sources of Data and Analyses Relating to Physical Fundamentals in International Commodity Markets," UN Conference on Trade and Development, June 2011. http://www.unctad.org/en/docs/osgdp20112_en.pdf

[xiv] "Commodity Futures Trading Commission (CFTC): Public Input for the Study Regarding the Oversight of Existing and Prospective Carbon Markets," Institute for Agriculture and Trade Policy, December 17, 2010. http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26767&SearchText=Institute%20for%20Agriculture%20and%20TRade%20Policy