Regulation of commodity derivatives markets

Markets for primary resources or commodities and their products (petrol, metals, CO2 quotas, agricultural products and markets for gas and electricity) are becoming more and more financialized. For certain commodity markets, the degree to which the volume of derivative products overshadows the volume of the physical market has become considerable over the course of the last few decades. These developments differ widely depending on the commodities in question.

Originally conceived as instruments to manage risks, the markets for financial derivatives on commodities also play an important role in price discovery and in the formation of price expectations for primary resources. Whereas physical markets understand the considerable peculiarities in function specific to each different commodity, the markets for financial derivatives on commodities resemble classical financial markets: their developments are strongly tied to the underlying physical markets and the fundamentals that drive them: supply, demand, and inventories. They distill at each moment the equilibrium conditions stemming from the physical market.

The spike in price volatility in 2007-8 gave rise to the fear of contagion from the financial sphere to the physical sphere: it was not merely changes in "fundamentals" which governed the price of primary resources, but also the movements observed in derivatives markets. For example, the price of agricultural products and derivatives on those products, in particular for grains, witnessed a strong price volatility during the years 2007-8, provoking spectacular price increases. The price of wheat futures contracts quoted on Euronext NYSE Liffe thus doubled in the space of six months at the start of 2007. If it was disconnected from the physical realities of the market, such an increase in the prices of agricultural products unfairly penalized producers just as much as it did consumers. The question of understanding the role of financial investors in the volatility of commodity derivatives markets is still not resolved.

This fear of contagion from the financial sphere to the physical sphere must be treated with special attention at all times, in order to restore the confidence of market participants in the suitability of commodity derivative markets: financial commodity markets suffer today from an incomplete and ill-suited European regulatory regime.

Physical markets today are not the object of real measures of supervision and surveillance. At the same time, just one section of commodity derivatives currently fall under financial regulations. The directive on financial instrument markets and their texts for application draw a distinction between two categories of commodity derivatives: financial instruments, and commercial futures. Only commodity derivatives with the qualification of financial instruments enter today under the scope of financial regulation. On top of this, there is supervision of commodity instruments that are traded on regulated markets.

Only "traditional" financial actors who participate in these markets are fully covered by financial regulation. Thus, numerous participants in derivatives markets, such as producers and suppliers of electricity or gas, or specialized *traders* in commodities markets, who constitute the majority of participants in the CO2 market, are not covered by financial regulation, even when they participate in financial derivatives transactions. Nor, therefore, are they subject to principles of good information, protection of client interests, and good execution. Moreover, these same actors are not subject to any capital requirements.

Commodity derivative markets are exposed to risk of abuse in specific markets. In effect, the regime for prevention and punishment of market abuse of existing "classic" financial instruments is not entirely adapted to commodity derivative markets. Such adaptations as exist have not demonstrated their effectiveness. For example, there is nothing planned for [new] regulation to discipline cross market manipulation between derivatives markets and physical markets.

The oversight framework of these commodity markets is not satisfactory: if financial regulators have an important role to play in the oversight of these markets, it is necessary to ensure that they understand the fundamental dynamics of physical markets, just as they would for financial markets. In this regard, the cooperation between financial regulators and sectoral regulators of certain commodity markets is today too limited.

A better regulation of European wide commodity derivative markets is therefore necessary today.

It is crucial that Europe is fully engaged from now on in the regulation of commodity derivative markets. France welcomes the recent significant regulatory advances under the aegis of the European Commission, particularly in gas and electricity markets. Though it is certain that progress will be necessary in each sector of the commodity markets, the Commission should likewise commit to a global regulatory approach.

Financial regulatory work, whether it be in over-the-counter derivatives, in the financial markets directive or the market abuse directive will have implications for the framework of regulating commodity market derivatives. Therefore, given the enormity of what is at stake in the revision of these texts, it necessary to ensure that issues relative to commodity markets are not forgotten on the way [to overall financial reform].

Given the foregoing, France believes that the European Commission usefully could undertake an initiative to draft a specific directive for the regulation of commodity derivative markets, drawing upon principles for regulatory action common to commodities and related products.

This legislative text could tackle the following issues:

- Propose the means to cover the field of commodity derivatives and like products (such as mixed swaps), by means of an ample definition of commodities;
- Think of the pathways between oversight of physical commodity markets and the regulation of commodity derivative markets
- Propose steps to ensure an oversight framework for all market participants relative to the scale of their market participation
- Consider a market abuse discipline based on a specific definition of privileged kinds of information and on the analysis of forms of market manipulation specific to commodity derivatives markets, above all in their interaction with physical markets;
- Pose the question of the necessity of a special treatment of over-the-counter derivatives in these markets;

- Inquire about the need to promote measures of increased transparency, above all in physical markets, in order to improve price formation mechanisms and to ensure the capacity of regulators to monitor the global operation of these markets
- To outline broadly the architecture of effective European wide oversight of commodity derivative markets, taking into consideration present regulatory options and the devolution of increased power to a European authority of financial markets.

France wishes to collaborate fully with the European Commission on a subject about which the stakes for the real economy of the Member States is considerable.