



Comment on a Revision of the European Commission Market Abuse Directive (MAD)

Steve Suppan, ssuppan@iatp.org

Institute for Agriculture and Trade Policy

23 July 2010

The Institute for Agriculture and Trade Policy (IATP), a U.S. headquartered non-government organization with offices in Geneva, Switzerland and Beijing, China, is pleased to have the opportunity to comment on the proposed revision of MAD. IATP, as a member of the Commodity Markets Oversight Coalition (CMOC), an alliance of over 80 commodity derivative users organizations, former Commodity Futures Trading Commission officials, hedge fund traders, farmer organizations and non-governmental organizations, played a small role in proposing provisions that were incorporated into the derivatives title of the recently passed “Wall Street Reform and Consumer Protection Act” (the Act). CMOC letters and testimony to Congress and the CFTC are posted at <http://www.nefiactioncenter.com/commoditymarkets.php>. IATP analysis on excessive speculation in commodities and related writing is posted at www.tradeobservatory.org. It is on the basis of our experience with the CMOC and the U.S. legislative and regulatory process that we submit this comment to enhance U.S.-EU regulatory cooperation on derivatives issues.

IATP is pleased that the Commission is proposing to extend the authority of MAD to cover Over the Counter (OTC) trades and trades on unregulated venues. Given the volume, value and volatility of OTC trades (\$300 trillion in notional value for U.S. markets alone in 2008, according to the Bank of International Settlements), it would be very difficult, if not impossible, to detect market abuse unless MAD were applied to OTC trades. During the past decade, U.S. regulatory exemptions for OTC swaps and failure to enforce position limits were major drivers in excessive speculation in wheat and oil contracts, as determined by U.S. Senate investigators and the French Ministry of Finance respectively.¹

The Act forces most OTC trades on to regulated exchanges and requires their daily reporting for the weekly CFTC Commitment of Traders (CoT) report. CFTC regulators will be able to determine market abuse, whether intentional or not, by timely and close scrutiny of the CoT data and the supplementary CoT reports for agriculture. The Act exempts only commercial hedgers and only to the extent that they are hedging commercial risk in commodities they trade or use, due to the higher transaction and margin costs of regulated exchange trading. Most of these exemptions will concern Small and Medium Enterprises (SMEs) with which the Commission is rightly concerned in its proposed revision of MAD. We agree with the

¹ <http://levin.senate.gov/newsroom/supporting/2009/PSI.WheatSpeculation.062409.pdf> and “Rapport du Groupe de Travail sur la Volatilité des Prix du Pétrole,” Ministère de l’Economie de l’Industrie et de l’Emploie, February 2010.

Commission about the need to adapt the revised MAD to the market practices of SMEs, as proposed on page 7 of the consultation document.

IATP believes that unless the Markets in Financial Instruments Directive (MiFID) is revised to force onto regulated exchanges non-SME OTC trades and to establish and enforce aggregate position limits in all EC trading venues, it will not be possible to enforce a revised MAD. A revision of the definition of “attempt at market manipulation” will be useful, by enabling regulators to act to prevent manipulation without having to prove intent to manipulate. However, if OTC trading continues to increase, e.g. in carbon derivatives under the Emissions Trading Scheme, the volume of infractions will overwhelm regulator enforcement capacity. We believe that the proposed revised definition of “attempt at market manipulation” would allow OTC traders to continue to take advantage of exchange price information while providing no timely price information for priced discovery, even as OTC lawyers battle with regulators over whether or not their trading reasons are “legitimate.” Since a statutory purpose of commodity derivatives markets is price discovery and OTC trades distort the price discovery process, greatly reducing the volume and value of OTC trading will narrow the opportunity for manipulation more effectively than a definitional refinement to “attempt at market manipulation.”

Due to lack of time, IATP is unable to answer most of the questions that the consultation document poses. We hope that there will be a future opportunity to respond to such questions regarding the revisions of MAD and MiFID. However, we would like to note, with regard to question 1, that a better definition of “inside information” is unlikely to suffice to better protect investors. Rather, the Commission may wish to consider whether allowing financial institutions to continue to own and trade physical commodities, such as oil and gas, gives them a legally protected inside information for the purpose of trading related energy derivatives contracts, particularly if such contracts continue to be traded OTC, on unregulated venues and without enforced aggregate position limits. Such consideration would not be within the remit of the revision of MAD, but it is certainly within the remit of the Commission and ECOFIN, as EU financial ministers deliberate the broader EC financial regulatory architecture.

While it may be argued that all market transactions attempt to “manipulate” the market, we believe that a clear distinction exists and should be maintained between exchange transactions and OTC transactions, whose delayed reporting incites rumor and investor “herd” behavior without contributing the timely price information, that exchange traded products contribute and that price discovery requires. Whether or not trades are accepted for clearing and whether or not cleared trades contribute to price discovery are among the “efficient criteria” that the Commission should use in the revision of MAD, per question 2. Our view implies a strong “yes” in response to question 3, since manipulation through a cascade of complex derivatives should be as forcefully prohibited as the simplest corner or squeeze on a physical commodity. With daily and comprehensive derivatives trade data disclosure, the Commission should be able to enforce a prohibition against manipulation via any derivative or combination of derivatives, as will be discussed in the MiFID review (p. 9 of the consultation document).

Regarding the Commission questions on “Cooperation with Third Countries,” we will not comment on current EC directives regarding enforcement. But we do believe the new U.S. legislation, by establishing a common standard of proof for triggering an investigation and common prosecutorial standard among the CFTC, Securities and Exchange Commission and other relevant regulatory agencies, has closed a much abused loophole in commodity derivatives

and the trading of physical commodities. If the EC lacks such a common standard, a revised MAD should adopt one.

Briefly, in response to question 9, we agree that a revised MAD should greatly reduce the reasons for regulators from one agency to refuse to share trading data and other relevant information with other regulatory agencies. At a time when mixed commodity and financial swaps are on the rise, and when the Bank of International Settlements classified about 12 percent of all 2008 OTC trades as “unallocated” in terms of their trading classification, to maintain the current “need to know” barriers is to invite regulatory enforcement breakdown.

While the Commission has a robust regulatory cooperation program with U.S. competent authorities, we believe that regulatory cooperation with third countries could be enhanced by opening up the International Organization of Securities Commissions (IOSCO) to entities other than government and exchange officials. In response to question 10, we believe that IOSCO facilitated consultations on draft technical committee documents, such as those of the commodity futures committee, would improve the quality of the documents and regulatory cooperation with third countries. The Commission should consider proposing such an initiative to ECOFIN to enhance cooperation with a revised MAD.

International organizations such as the FAO/WHO Codex Alimentarius Commission and the World Intellectual Property Organization have benefited by the interventions of accredited non-governmental and industry organizations. There is no reason to expect that regulatory cooperation would be impeded by opening up IOSCO to a broader array of stakeholders. Indeed, given what the Group of 20 financial ministers is mandating IOSCO to do², greater input than that of competent authorities is needed urgently for more effective cooperation with third countries and for more robust regulation.

EC market regulation and regulatory cooperation has consequences outside of the EC markets directly affected by the revision of MAD. It perhaps goes without saying that what the UN Conference on Trade and Development (UNCTAD) calls the “financialization of the commodity markets” has induced global market volatility that cannot be explained in terms of supply, demand and other market fundamentals.³ As a recent UNCTAD secretariat paper informed UNCTAD (including G-20) member governments, “highly volatile commodity prices act as a serious distortion on the development process.”⁴ Effective revision and enforcement of MAD and MiFID will help to reduce that distortion.

IATP thanks the Commission for their consideration of these comments and looks forward to commenting on the revision of MAD and other financial and commodity market directives.

² “Communiqué: Meeting of Finance Ministers and Central Bank Governors,” Group of 20, April 23, 2010.

³ http://www.unctad.org/en/docs/tdr2009_en.pdf

⁴ “Recent developments in key commodity markets: trends and challenges,” UNCTAD secretariat, January 12, 2010, at 11. http://www.unctad.org/en/docs/cimem2d7_en.pdf