Task Force on Commodity Futures Markets

Report to the G-20

TECHNICAL COMMITTEE
OF THE
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

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Executive Summary

The IOSCO Technical Committee created the Task Force on Commodity Futures Markets[1] (Task Force) in September 2008 in response to global concerns, including those voiced by the G-8 Finance Ministers, concerning price increases and volatility in oil prices. Responding to these concerns, the Task Force met and authored a report in March 2009 containing recommendations for improving commodity derivative regulation by securities and futures regulators. The G-20 Leaders endorsed these March 2009 recommendations in their September 2009 Pittsburgh Leaders' Statement, called on the Task Force to collect more oil market data and requested further recommendations on ways to reduce volatility in energy prices.

This Report describes the progress that has been made by the Task Force since its June 2010 Report to the G-20 and our plans going forward. In order to put this work in context, the Report also reviews briefly certain aspects of the Task Force's March 2009 Report, which provides the overall framework for understanding the various ongoing work-streams.

Over-the-Counter Commodity Derivatives Market Transparency

- The Task Force's work continues to be informed by the conclusion in its March 2009 Report that price discovery in the financial commodity markets, as well as analysis of the interactions between the financial and cash commodity markets, should be improved by promoting greater transparency across futures, over-the-counter (OTC) derivative and cash commodity markets.

- We have focused our recent work on promoting transparency in the OTC commodity derivative markets because transparency in the organized futures markets is well established, and the physical markets are typically beyond the jurisdiction of IOSCO's securities and derivatives regulators.

- The Task Force recognizes the importance of transparency in both financial and physical commodity markets because these markets are interrelated; asymmetry of information in either can hinder the process of price discovery. The interdependence between cash and futures prices and fundamentals of the underlying market is likely to lead to wide-ranging consequences where there is a lack of information or the provision of misinformation. As financial regulators we have chosen to focus our

[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: 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); Kredittilsynet (Norway), Monetary Authority of Singapore (Singapore); Capital Market Authority (Saudi Arabia); and Swiss Financial Market Supervisory Authority FINMA (Switzerland).

efforts on what are considered the main areas of concern in the financial trading of oil. A more detailed rationale for this pursuit of transparency is set out in Appendix I to this report.

- In furthering the objective of transparency, we have reached out beyond major dealers to include, to the extent practicable, a broader subset of OTC derivatives participants in oil; supported the prior commitments made by the Commodities Major Dealers (CMD) group in OTC oil derivatives to the OTC Derivatives Supervisors Group; encouraged the completion of a survey of major oil market participants to better understand market practices; and encouraged consensus for a trade repository for OTC oil financial derivatives.

- We also reached out to the Bank for International Settlements (BIS) to promote the enhancement of published BIS data on energy derivatives. However, the Committee of the Global Financial System (CGFS), the division that collects these statistics for the BIS semiannual report on OTC data, is reluctant to disaggregate bank OTC data for oil due to its "modest value." CGFS notes that publication of the disaggregated data has limited value because of the time lag prior its semiannual publication and the high level of aggregation.

Legislative Initiatives relating to OTC Markets

- The Task Force notes that Japan and the United States have adopted OTC derivatives market reforms and the European Union has proposed OTC market reforms. Although this is complimentary to the Task Force work it is essential to understand the measures presented to the G-20 in answer to its call relating to financial markets. These legislative efforts will significantly improve the transparency and oversight of the OTC derivative market, including OTC financial oil products. They include measures to increase the percentage of transactions which are traded on platforms, to increase the percentage of transactions which must be submitted for clearing, to improve the proportion of transactions which are standardized and can be submitted for clearing; to improve post trade transparency; to provide for the reporting of transactions to trade repositories and to enhance markets operational efficiency.

- 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 lesser regulated jurisdiction.

Futures Market Transparency

- In response to expressions of interest from Task Force members, in the summer of 2010 the U.S. Commodity Futures Trading Commission conducted a seminar on the policies and practical aspects of establishing a large trader reporting system and publishing aggregated data in its Commitments of Traders reports. The Task Force has recommended that jurisdictions publish more aggregated open interest data. Certain Task Force members, particularly those with significant exchange-traded markets, are already moving toward gathering information and publishing reports covering their jurisdictions.

Physical Cash Market Transparency

- Although the Task Force is constrained in its ability to advance greater transparency of underlying physical market transaction data due to lack of jurisdiction, the Task Force reiterates that information about the underlying commodity is key – indeed critical – for the satisfactory functioning of financial markets and reliable price discovery. The main purpose of financial futures and OTC derivatives markets is to express an expectation of future prices in the physical cash markets. So the basis on which these expectations are formed is critical.

- As for oil in particular, the Task Force therefore encourages the International Energy Agency (IEA), the International Energy Forum (IEF) and the Organisation of the Petroleum Exporting Agencies (OPEC) to further improve the reporting by their members with regard to the completeness and timeliness of physical oil data. Better physical oil data (production, inventories, transport capacities etc.) will allow for increased understanding of the linkages between the physical and financial markets for oil. The Task Force will actively engage with relevant initiatives as they are developed.

Price Reporting Agencies

- The Task Force again notes that the *Tokyo Communiqué* (1997), which set out internationally accepted *Guidance on Standards of Best Practice for the Design and/or Review of Commodity Contracts* and *Guidance on Components of Market Surveillance and Information Sharing*, continues to provide an effective roadmap for addressing contract design and surveillance issues that are of continuing concern with respect to oil futures markets.

- Information provided by price reporting agencies such as Platts and Argus plays a critical role with regard to the design of commodity futures contracts and as a basis for the floating price component for settlement of swap contracts. A futures or swap contract that references an opaque price series could be more susceptible to manipulation.

- IOSCO members responsible for the oversight of commodity futures and swap markets should examine their relevant market authority to determine whether the cash commodity reference price on which pricing of the futures or swaps is based is reliable. In circumstances where the reliability of cash market reference prices cannot be demonstrated, the relevant market authority should engage with the price reporting agency to develop a more robust price series.

Ongoing Work

- The Task Force has committed to collaborating with the CMD and ISDA Commodities Steering Committee to work towards the formation of a trade repository for commodities. The initial focus will be on financial oil derivatives, considering the necessary details of each product and the data fields to be included. This work will be set against the context of legislative initiatives, detailed later in the report, which call for the setting up of trade repositories.

- The transparency and functioning of cash markets for commodities remains a prominent concern. In order to address this, the Task Force recommends that a detailed study of the issues facing physical markets from the impact of price reporting agencies be undertaken. An international physical market agency should coordinate to lead this study. The Task Force is ready to engage in the study to assist with financial market considerations.

Chapter 1 OTC Derivatives Market Transparency Initiatives

As noted in the June 2010 Task Force Report[2], the Task Force has initiated work on multiple fronts to promote better transparency of OTC oil derivatives data. The Task Force focused on OTC commodity markets because transparency in the organized futures markets is well established, and the physical markets are largely beyond the jurisdiction of IOSCO's securities and derivatives regulators. As explained in Annex I to this report, the overall objective in fostering better transparency in all commodity markets – futures, OTC derivatives and underlying cash markets – is to facilitate accurate price discovery and provide data that will help to understand better the price relationships between the financial and cash commodity markets. Improved transparency also aids in assisting market regulators in identifying market abuses in futures and OTC markets. The following sections of the Report describe the status of this work.

A. Initiatives with Major OTC Derivatives Participants

The Task Force is working with major OTC derivatives participants, through the Commodities Major Dealers (CMD) which is made up of the G-14 major dealers,[3] who had previously made initial commitments to the OTC Derivatives Supervisors Group[4] with respect to achieving enhancements in transparency, central clearing, standardization, collateral and operational efficiencies in the OTC derivatives markets in a variety of asset classes.

The Task Force's objective in engaging with these major OTC participants has been to determine:

1. if work could be expanded and accelerated with respect to transparency in OTC oil derivatives and if so;

2. to broaden the participation in this work to include a geographically diverse group of dealers, producers and end-users.

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2 *IOSCO Technical Committee Task Force on Commodity Futures Markets: Report to the G-20.* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD324.pdf

3 The CMD are the group of 14 major dealers including Bank of America-Merrill Lynch, Barclays Capital, BNP Paribas, Citigroup, Credit Suisse AG, Deutsche Bank AG, Goldman Sachs & Co, HSBC Bank USA N.A., JP Morgan Chase, Morgan Stanley, RBS Sempra, Société Générale, UBS AG and Wachovia Bank, N.A., http://www.newyorkfed.org/newsevents/news/markets/2010/ma100301.html

4 The OTC Derivatives Supervisors Group is comprised of: Board of Governors of the Federal Reserve System; Connecticut State Banking Department; Federal Deposit Insurance Corporation; Federal Reserve Bank of New York; Federal Reserve Bank of Richmond; French Secretariat General de la Commission Bancaire; German Federal Financial Supervisory Authority; Japan Financial Services Agency; New York State Banking Department; Office of the Comptroller of the Currency; Securities and Exchange Commission; Swiss Financial Market Supervisory Authority; and United Kingdom Financial Services Authority; and Commodity Futures Trading Commission. The European Commission and European Central Bank hold observer status.

These broad objectives have been substantially achieved within the following initiatives:[5]

- **Broadened participation in the Task Force's oil markets transparency work-stream beyond major dealers**

The Task Force worked to obtain broader participation in the oil market transparency initiatives by encouraging interaction between the CMD and the ISDA Commodity Steering Committee (COSC)[6], which includes non-dealers such as producers (some of whom act as dealers for financial oil) and major users of commodities. Both groups were encouraged to engage key industry groups. The cooperation between these two industry groups is expected to result in COSC members working to meet future CMD goals for OTC oil laid out by the OTC Derivatives Supervisors Group, although no such commitment has been made from market participants outside the CMD.

- **Support the prior commitments by the Commodity Major Dealers group in OTC oil derivatives**

Commitments that the CMD has already made to the regulatory community are set out in the CMD's letter of December 7, 2009[7]. These commitments, which focus on the following five objectives, are intended to strengthen the resilience and robustness of the OTC commodity derivatives infrastructure:

- increased transparency through enhanced metrics and reporting for Supervisors;
- increased electronic processing including formal targets for electronic matching of eligible OTC energy and metals transactions;
- increased standardization of documentation and "take-up" of standardized documentation;
- continued support for cross-asset class collateral practices and related commitments;
- continued reporting of OTC cleared volume as a proportion of total OTC volume; and
- and continued focus on operational improvements by adopting ISDA Best Practice recommendations for the wider marketplace.

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5 These initiatives were described in the Task Force's June 2010 Report to the G-20.

6 The COSC is the first level of governance – sitting above relevant implementation groups and working groups – operating under the auspices of the ISDA Industry Governance Committee (IIGC). COSC includes representatives from CMD as well as major "buy-side"firms, commodity producers and traders.

7 The commodities commitments are set out in a letter dated December 7, 2009 to the OTC Derivatives Supervisors Forum, available at: http://www.newyorkfed.org/newsevents/news/markets/2009/060209table.pdf and http://www.isda.org/c_and_a/pdf/CMD-CommoditiesSupervisoryLetter.pdf.

This included providing a set of core metrics on energy, metals and *other* commodities[8] which are delivered monthly to the OTC Derivatives Supervisors Group on an on-going basis.

The CMD has successfully delivered on all commitments to date, as originally set out in the December 2009 Supervisory Commitment letters, including targets for electronic confirmations of eligible energy and metals transactions.

Key examples include:

- o Established and met electronic matching confirmation targets for eligible Energy and Metals trades between the CMD:
  - o 90% for eligible energy transactions (95% actual - June 2010)
  - o 85% for eligible metals transactions (91% actual - June 2010).

- o Institutionalized daily collateralized portfolio reconciliation between the CMD, in line with Cross Asset Class commitments in Collateral Management. Met incremental requirements as outlined in ISDA Collateral Implementation Team commitments.

- **Encouraged a survey of major oil market participants to better understand key market practices**

At the request of the Task Force, the CMD and COSC surveyed a broad sample of OTC derivatives market participants in financial oil products in order to develop a better understanding of the size and composition of the OTC oil financial derivatives market and the market practices of those surveyed participants' key market practices. For the purposes of the survey, OTC financial oil transactions are primarily intended to be those where there is no intention of physical settlement. The purpose of the survey was to identify the percentage of derivative business conducted on exchange, the percentage of *OTC Cleared* business, the eligibility and usage of electronic confirmation, the extent of collateralization for non-cleared activity and if non-CMD participants behave differently from the CMD participants.

There were 41 participants in the survey, either CMD or COSC members. Links were established with other industry bodies, to publicize the survey and encourage wider participation. The survey however contains a number of limitations that require it be interpreted cautiously. Participation in the survey was voluntary and represents participants' oil derivatives activities for May 2010 only. Additional limitations include the sample size and composition relative to the broader market for oil derivatives[9], the degree of granularity of the definitions and participants' understanding of those definitions, and the fact that the survey reported aggregate data that averaged the practice for each market participant rather than a volumetric average.

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8 *Other* commodities include agricultural, softs, weather, emissions, freight, coal and derivatives based on commodity indices.

9 There were 41 survey participants. 12 were CMD firms. 29 were non-CMD firms. Of the 29 non-CMD firms, 23 have identified themselves to the Task Force. Of the 23 identified firms, 14 can be classified as financial institutions and a number of producers also act in a dealer capacity for financial oil. None of the survey participants were strictly commercial "end user," or were many firms buy-side hedge funds.

Despite these limitations, the information provided by the survey results is valuable in that it represents the first systematic attempt to measure both dealer and non-dealer trading activity in the OTC oil derivative markets.

The results of the survey, as shown in Table 1, indicate that market participants conduct a majority of their business either 1) on exchange and thus cleared (on average 55% of a survey participants' trades) or 2) OTC cleared (on average 19% of a survey participants' trades). However, on average firms continue to complete 27% of their deal volume OTC uncleared, which carry bilateral counterparty risk for those trades. When breaking survey respondents into CMD and non-CMD groupings a clear trend emerges that CMD firms transact a smaller proportion of their business uncleared (14%) relative to non-CMD firms where the average figure is 33%.

In speaking with these market participants the Task Force learned that while some of these OTC uncleared transactions were collateralized, a high percentage were not. Many of these transactions may be with end-users, for whom other credit arrangements may be deemed more appropriate. We do understand that bilateral arrangements, other than collateral, may be used, and that many market participants devote significant resource to credit management.

Further, the Task Force discussed with COSC co-chairs whether there might be material differences had the survey been conducted for a longer or different period than one specific month, or on the basis of volume as opposed to numbers of trades. The co-chairs opined that while it is clearly not possible to determine this authoritatively without further data, they believe that material differences would be unlikely to arise.

Table 1

	Financial Oil (crude and refined product)[10]	**Crude Oil**	**Refined Products**
Exchange Traded	55%	61%	52%
OTC Cleared	19%	18%	14%
OTC Uncleared	27%	21%	33%

Composition of the Market

During a recent meeting Task Force members arrived at a general belief, based on conversations with industry participants, that the composition of the OTC oil derivative market participants is broader than for other asset classes, such as CDS. The results of the ISDA survey support that assumption. For OTC uncleared transactions, on average only 19% of transactions were transacted facing a CMD firm. When the reporting firm was a CMD

10 While the statistics for Financial Oil are a representative aggregate for the two sub-groups of Crude Oil and Refined Product these are not derived directly from the data provided for the individual sub-groups.

firm, the likelihood of an OTC uncleared transaction being conducted with another CMD firm was 10% on average, whereas the figure was 23% for non-CMD respondents.

The results suggest that the majority of OTC uncleared deals do not face CMD firms, which supports the theory that participants in the OTC financial oil market are more diverse in nature than other asset classes. This information from this survey highlights the importance of broad participation in a trade repository that includes oil derivative products and the need for harmonized reporting obligations to regulatory authorities.

Geographic Composition of the Market

eConfirm is a service provided by Intercontinental Exchange (ICE) that allows market participants' back office functions to confirm the trade terms of OTC derivative transactions electronically, rather than faxing confirmations. In energy, particularly oil, eConfirm has an active confirmation service used by various market participants, so the Task Force asked for May 2010 aggregate data to provide a picture of the OTC oil market. eConfirm provided aggregate data for the 10 most liquid swaps in North America, Europe and Asia.

The data set out in Table 2 shows significant activity in the most liquid swap but very little in the tenth most liquid swap. In terms of geographical differences Asia was the most active region, and North America the least active[11]. Potential factors for this relationship may be the relative lack of liquidity on exchange-traded benchmarks in Asia – comparable to that of Brent or West Texas Intermediate (WTI) – and the fact that Asia is a significant oil consuming region.

The data contains a number of limitations that may require cautious interpretation. Aggregate data was provided for May 2010 only and the different quantity unit denominations of the various swaps make it harder to gauge relative volumes across the board. However, this data demonstrates the global distribution of OTC oil trading and the importance of creating harmonized OTC regulation in all nations with financial markets.

Table 2

	North America	**Europe**	**Asia**
# of transactions confirmed, May 2010	270	1470	1669
# of transactions in most liquid swap	100	314	389
# of transactions in 10th most liquid swap	3	58	1

- **Encouraged consensus for a trade repository in OTC oil financial derivatives among dealers and non-dealers**

[11] If considered on a barrel-equivalent basis Europe was the most active region, closely followed by Asia, while North America remained least active

The G-20 members have agreed to have their derivative market participants report all OTC derivative transactions to trade repositories by the end of 2012[12]. The use of trade repositories significantly increases the position 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.

Industry participants, through the OTC Derivatives Supervisors Group, have already created three trade repositories for three different asset classes. Warehouse Trust, which is regulated by the Federal Reserve and New York State Banking Department, acts as a trade repository for credit default swap (CDS) transactions. TriOptima, based in Sweden, acts as a trade repository for interest rate swaps and MarkitSERV, based in London, acts as a repository for equity derivative transactions. These trade repositories were selected by industry via a request for proposal (RFP) process coordinated by ISDA and collect varying degrees of data from simple execution data to full lifecycle reporting.

As part of the industry-wide usage of trade repositories, CMD and ISDA COSC have taken steps to commence to build a consensus and support for a trade repository among dealers and non-dealers for financial commodity products. In response to Task Force discussions, this effort has been prioritized for OTC financial oil products and the CMD and ISDA COSC are expected to take this initiative forward by the end of 2010. The industry group is working to develop a RFP in early 2011. The IOSCO Task Force has encouraged this objective, and plans to contribute to the specification of any trade repository, but has not involved itself in the selection process.

National governments have reinforced industry initiatives favoring the use of trade repositories by legislation passed or pending in major market jurisdictions. For example, in July 2010, the United States Congress passed legislation mandating that the CFTC and SEC create rules regarding the registration, data collection and reporting by swap data repositories. On September 15, 2010, the European Commission proposed in their "Regulations on OTC Derivatives, central counterparties and trade repositories" to mandate the collection of all European based OTC derivative transactions in trade repositories. This trade repository system would be regulated by the newly established European Securities and Markets Authority (ESMA). Additionally, in July 2009 the Japanese Diet passed an Amendment to the Commodity Exchange Act, which among other things, requires that transactions in certain OTC commodity derivatives be reported to the competent minister. This legislation allows market regulators to identify potential market abuses, even in the case where there is no trade repository that would accept certain OTC transactions.

These legislative efforts will significantly improve the transparency of the OTC derivatives market, including the OTC market in financial oil products. However, financial 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

[12] Paragraph 13, Leader's Statement: The Pittsburgh Summit, September 25, 2009, available at, http://www.pittsburghsummit.gov/mediacenter/129639.htm

transact in a lesser regulated jurisdiction.

Recommendation: That IOSCO and the G-20 emphasize that regulators promote the adoption of measures to regulate the OTC derivatives market consistent with the G-20 recommendations. A particular focus should be made with regard to the formation of a commodities trade repository. Any future trade repository should carefully examine which contracts are appropriate to be reported to a trade repository based on the characteristics of contracts and market practices. Regulators should coordinate internationally in order to avoid differing standards and to ensure regulators can have a total view of these global markets.

B. Initiative with the Bank for International Settlements

- **Requested the enhancement of published BIS OTC data on energy derivatives**

In September 2009 the Task Force co-chairs contacted the BIS Committee on the Global Financial System (CGFS) to request that OTC energy/oil be reported separately from aggregated semi-annual OTC commodity derivative statistics. The letter requested disaggregation of other commodities from BIS OTC derivatives data where they are *economically significant.*

In June 2010, that broader request subsequently was narrowed to oil, specifically for disaggregation of OTC oil derivative data in the *BIS Quarterly Review* and *Semiannual OTC Derivatives Statistics* publications.

The rationale for this request – discussed more generally in Annex I to this report – is that further granularity of BIS statistics would enable market participants to make better informed, more rational decisions, and would be an important supplement to pending additional regulatory transparency of OTC oil transactions, the combination of which should reduce volatility in that market. This is particularly important in times of market stress where concerns over counterparty risk permeate. In this situation market participants can make decisions based on an improved understanding of the size of exposures.

Further disaggregating the BIS OTC commodities data would be a highly significant step in advancing these efforts. The existing BIS data demonstrates the changing nature of OTC commodity derivative markets. Proportions of gold and precious metals reported relative to the total notional amount outstanding for commodities has declined from a maximum of 57% in the first half of 1999 to a minimum of 6% in the first half of 2008. At the end of 2009 the Other Commodities category comprised 82% of total notional value reported for OTC commodity derivatives, a proportion which would likely benefit from being broken down in to constituent elements.

Disaggregation of OTC oil derivatives data from other commodities would be a valuable improvement in the granularity and transparency provided by the BIS data. Given the economic significance of oil, particularly its impact on growth, correlation with other financial assets and its significance for determining monetary policy through inflation, disaggregation of the highly valuable BIS OTC data to specify oil would likely benefit the whole financial system as well as the understanding of the wider global economy.

Status: The Task Force supplemented this request with an explanation requested by the CGFS of the benefits that would accrue to central banks from disaggregating OTC oil market products from the BIS reports. However, after considering this request, BIS CGFS declined to further disaggregate their data, citing that the publication of disaggregated bank OTC data has limited value because of the time lag prior to its semiannual publication and the high level of aggregation.

Chapter 2 Futures Market Transparency

A. Encouraged the publication of exchange-traded derivatives data

The June 2010 Task Force Report noted that in response to expressions of interest by Task Force members, the CFTC arranged a seminar to share its experience in the design of a large trader reporting system and the publication of such aggregated futures market data to the public in a weekly report called the Commitments of Traders Report. The seminar took place June 3-4, 2010 and was attended by representatives from eight Task Force member jurisdictions.

As designed by the CFTC, the large trader reporting system is used by market surveillance staff to assess an individual trader's activities and potential market power and enforce position limits. Under this system, brokers, exchange clearing members and foreign brokers file daily reports with the CFTC that show futures and options positions on traders with positions at or above specific reporting levels set by the CFTC. If, at the daily market close, a reporting firm has a trader with a position at or above the CFTC's reporting level in any single futures or option expiration month, the firm reports that trader's entire position in all futures and options expiration months in that commodity, regardless of size.

The aggregate of all large trader positions reported to the CFTC usually represents 70 to 90 percent of the total open interest in any given market. The reporting level for large trader reports can range from 25 contracts to over 1,000 contracts. The level for any given market is based on the total open positions in that market, the size of positions held by traders in the market, the surveillance history of the market, and the size of deliverable supplies for physical delivery markets. Aggregate data [13] concerning reported positions are published by the CFTC in its weekly Commitments of Traders (COT) reports and are broken out to four categories: Producer/Merchant/Processor/User; Swap Dealer; Managed Money; and Other.

Recommendation: The Task Force encourages the publication of large trader position reports similar to COT for the relevant on-exchange contracts. A number of jurisdictions represented in the Task Force are currently considering publishing the reports.[14]

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[13] The data are aggregated to protect the identity of any individual reportable trader.

[14] Aggregated data should ideally combine all relevant available sources, including exchange-traded , OTC cleared and OTC uncleared. However, aggregation loses its value when the original individual subsets of data are compiled using different methodologies or parameters.

Chapter 3 Physical Cash Commodity Market Transparency

A. Encouraged greater transparency of underlying physical commodity market transactions

As noted earlier, the Task Force has focused its recent efforts on achieving greater transparency in the OTC financial commodity markets. This was a practical decision based on the fact that transparency in the organized futures markets is well established, and the physical markets are beyond the jurisdiction of IOSCO's securities and derivatives regulators (who regulate the *financial* derivatives markets).

Nonetheless, the Task Force reiterates that, information about the underlying commodity is key – indeed critical – for the satisfactory functioning of the futures market and reliable price discovery.

The Task Force notes that the International Energy Agency (IEA), the IEF and the Organisation of the Petroleum Exporting Agencies (OPEC) have recognized the need to improve reporting by their members with regard to the completeness and timeliness of physical oil data. Better physical oil data will allow for increased understanding of the linkages between the physical and financial oil markets.

The Task Force supports these efforts and encourages work that will foster better transparency of fundamental cash market data as they are developed.

B. Price Reporting Agencies

- **Background on the reliance by financial and cash markets on price reporting agencies**

In its June 2010 Report, the Task Force recommended an impact study to assess the role of price reporting agencies and their influence in physical markets. The Task Force suggested that an international body with involvement in physical energy markets with collaboration from appropriate interested parties undertake this work.

That recommendation followed the Task Force's previous recommendation in its 2009 Report[15] that in view of the degree to which price reporting agencies' data is relied upon by markets and commercial users, ways in which the reliability of the cash market data could be improved should be considered. For example, the 2009 Report suggested requiring the accountability for false and misleading data, encouraging the development of best practices and the increase of transparency of methodologies. An international physical market agency should consider the role of price reporting agencies on commodity markets. It is essential that any study encompasses representation for physical and financial market perspectives as these agencies provide services to a broad spectrum of participants within commodity markets. Again, the Task Force will assist with financial market considerations of any relevant studies.

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[15] *IOSCO Technical Committee Task Force on Commodity Futures Markets: Final Report (March 2009)* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD285.pdf

The core concern with respect to price reporting agencies is the extent to which the reported data accurately reflects the cash market in question. Such accuracy is particularly important where such reported data is referenced for settlement price purposes in financial commodity derivative contracts.

- **Underlying cash market reference prices play a critical role in futures and swap contracts**

Regulators have an interest in ensuring the proper design of commodity derivative contracts. This is because the proper design of the terms and conditions of commodity contracts reduces the susceptibility of such contracts to market abuses, including manipulation. Moreover, the consideration of appropriate contract design principles by market authorities complements surveillance and is a critical aspect of market integrity.

The critical role that underlying cash market prices play in the proper design of futures markets was thoroughly examined in the *Tokyo Communiqué's* G*uidance on Standards of Best Practice for the Design and/or Review of Commodity Contracts (contract design guidance).* More detail on this is given in Annex II to this report.

Recommendation: Information provided by price reporting agencies plays a critical role with regard to the design of commodity futures contracts and as a basis for the floating price component for settlement of swap contracts. A futures or swap contract that references an opaque price series could be more susceptible to manipulation.

Therefore, the Task Force recommends, consistent with the *Tokyo Communiqué's* contract design guidance, that IOSCO members who are responsible for the oversight of commodity futures and swap markets examine the current practices by "market authorities"[16] that are applicable to the design and/or review of commodity futures contracts and settlement of swaps contracts. IOSCO members should determine the extent to which those practices take into account the standards of best practice as set forth in the contract design guidance with particular emphasis upon the reliability of the cash reference price.

16 The *Tokyo Communiqué* sets out that, *'"market authority" may refer to a governmental regulator, a self-regulatory organization or an exchange'.* For the purposes of this recommendation "market authority" refers to the regulator of the market, whether on-exchange or OTC, and could be a government body, self-regulatory organization or an exchange (or several of these). "Government body" could include a public prosecutor or the courts.

Chapter 4 Ongoing Work

A. Formation of a Trade Repository for Commodities

The Task Force has committed to collaborating with the CMD and ISDA COSC to work towards the utilization of a commodities trade repository. These industry associations have chosen to initially focus on a number of key contracts within energy, namely financial OTC crude oil, gasoline and heating oil. Work will comprise identifying potential sources of data and ensuring that the framework is appropriate to take into account the differing characteristics of these particular markets.

B. Impact of Cash Market Reference Prices

There remains an unanswered question over the impact of published cash market prices on related commodity futures. Accordingly, this matter encompasses both the physical and financial markets for a particular commodity. An international physical market agency should coordinate and study cash market assessments. The Task Force is ready to engage in the study to assist with financial market considerations.

Appendix I Why Transparency Is So Critical for Commodity Markets

This Report builds upon the Task Force's March 2009 Report, which responded to global concerns voiced by the G-8 Finance Ministers[17] concerning price increases and volatility in oil and food products as well as similar expressions of concern voiced within IOSCO. The March 2009 Report addressed concerns as to whether supervisory approaches were keeping pace with market developments, including the participation of new categories of traders such as index funds, whether transparency in commodity markets was sufficient in light of ongoing concerns, and whether supervisory and enforcement cooperation could be improved.

The March 2009 Report specifically addressed the issue of volatility and the role of new participants in the futures markets. Based upon a literature review, the Task Force concluded that the reports reviewed by the Task Force did not support the proposition that the activity of speculators has systematically driven commodity markets or futures prices up or down on a sustained basis. The reports reviewed suggested that economic fundamentals, rather than speculative activity in financial commodity markets, were a plausible explanation for the then recent price increases in the commodity markets. Analysis of commodity market developments from the International Monetary Fund in its April 2010 World Economic Outlook supports the view that economic fundamentals are driving the rise and fall of commodity prices[18].

The March 2009 Report recognized that these conclusions reflected the application of statistical tests to available data, but that market complexities and significant data limitations left a need for better information – with respect to the underlying physical market and with respect to the financial commodity markets (i.e., futures and OTC)[19]. A March 2010 report of a French working group recognized the limitations of applying statistical tests to available, but limited, information: *"The complexity of interactions between the physical and the financial therefore restricts any unequivocal explanation of the massive oil price variations*

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[17] The G-8 Finance Ministers also raised strong concerns at their June 2008 Meeting in Osaka, Japan about the sharp rise in oil and food prices and the impact on global macro-economic stability as well as peoples' welfare and development prospects. The G-8 Finance Ministers specifically called for "national authorities to examine the functioning of commodity futures markets and to take appropriate measures as needed." *Statement of the G-8 Finance Ministers Meeting*, June 14, 2008, Osaka, Japan http://www.mof.go.jp/english/if/su080614.pdf.

[18] *IMF World Economic Review, Rebalancing Growth* (April 2010) at pp. 27-42. http://www.imf.org/external/pubs/ft/weo/2010/01/pdf/text.pdf

[19] A 2010 OECD report found that "there is no statistically significant relationship indicating that changes in index and swap fund positions have increased market volatility…. The evidence is not as strong in the two energy markets studied here because of considerable uncertainty about the degree to which the available data actually effect index trader positions in these markets." Irwin, S. H. and D. R. Sanders (2010), "The Impact of Index and Swap Funds on Commodity Futures Markets; Preliminary Results, "OECD *Food, Agriculture and Fisheries Working Papers No. 27.* http://www.oecd.org/dataoecd/16/59/45534528.pdf

In an update of its 2008 report *"The Oil Markets: "Let the Data Speak for Itself",* the EDHEC-Risk Institute examined data published by the US CFTC and concluded that "after adjusting speculative indices for index fund positions, values are within the historical ranges reported in prior research" dating to1960. *See "Has There Been Excessive Speculation in the US Oil Futures Markets?*" EDHEC-Risk Institute (November 2009). *http://docs.edhec-risk.com/mrk/000000/Press/EDHEC-Risk_Position_Paper_Speculation_US_Oil_Futures.pdf* *in the recent period"*[20].

There is considerable research on the relationship between changes in oil prices precipitating movements in financial markets, traditionally testing a negative relationship between the oil price and stock prices[21] with a resulting range of conclusions. Diversity of opinion in this research may exist because the relationship is more complex than a purely linear connection between the oil price and stock prices, hence open to a variety of interpretations. A contributing factor to this lack of clarity in understanding may be an incomplete picture of oil derivatives trading, which would be aided by publication of additional aggregate information on these markets.

Nevertheless there is an obvious changing dynamic of commodity markets, including oil, through a pronounced increase in financial institution participation, suggesting growing interdependence between the financial and physical markets. Research published in the *BIS Quarterly Review*, March 2007 highlighted this trend which has continued[22]. From published BIS data, investment in commodity derivatives peaked at over $13trn notional outstanding in H1 2008, and has subsequently fallen to approximately $3trn in H2 2009 – more than five times the notional value outstanding for H2 1999.

In either case of price-causality from financial markets to commodities or in reverse, there is a potential benefit from providing further information to improve transparency to the growing variety of participants in commodity markets, contributing to improved understanding and price formation.

The reason why better fundamental cash market information is needed flows from the fact that commodity futures markets are price discovery markets, in which the futures price tracks the prices of and signals information and expectations about the direction of the underlying markets.

The quality of the price which the futures market discovers reflects the extent to which the market understands available underlying data and the quality of that data. If data is inadequate, or of poor quality, it makes it difficult for futures regulators to determine accurately whether or not certain activity or price movements are unusual[23]. Accordingly, information about the underlying commodity is key for the satisfactory functioning of the futures market and reliable price discovery. Better data will also facilitate the economic and financial statistical analysis of the price relationships among cash and financial markets.

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20 *See Oil Price Volatility, Report of the Working Group Chaired by Professor Jean-Marie Chevalier (March 2010).* The Report noted that: "Nor do available statistical data establish clearly the links of causality between the open positions of financial investors in futures markets and the prices observed in the spot market. On the other hand, nothing suggests these links can be excluded."

21 One example of this type of study is: Miller, J.I. & Ratti, R.A., (2009) "Crude Oil and Stock Markets: Stability, Instability and Bubbles", *Energy Economics*, Vol. 31, No. 4, pp. 559-568.

22 The following research provides useful background to the changing nature of commodity markets due to financial participation among other factors, indicating the need for transparency of financial participants actions in commodity markets: Domanski, D. & Heath, A., (2007) "Financial Investors and Commodity Markets", *BIS Quarterly Review,* Bank for International Settlements, March 2007.

23 *See* the Task Force's 2009 Report, p. 11 for this discussion and related foot-note citations to supporting studies.

Transparency with respect to the financial commodity markets – futures and OTC – is also critical not only for understanding the causal relationships between financial and cash markets activity, but also for market integrity purposes. In this regard, the Task Force's 2009 Report reiterated a key point in the *Tokyo Communiqué* that remains highly relevant to contemporary surveillance concerns. Specifically, authorities that are responsible for market surveillance should be able to access sufficient information about futures and related cash positions in order to identify dangerous concentrations of positions, to evaluate overall composition of the market and to assess its functioning. Obtaining such information across the markets assists regulators in determining a large trader's intentions in respect of a particular commodity.

Many of the recommendations in the March 2009 Report were intended to address these informational needs. For example, that Report called for:

- continued monitoring of the futures markets in order to improve understanding of futures price formation and the interaction between regulated futures markets and related commodity markets;[24]

- improvements in transparency with respect to the availability and quantity of information on commodities;

- greater cooperation and the sharing of information among futures market regulators;

- ensure that futures market regulators have the necessary legal framework to detect and take enforcement action with respect to manipulation; and

- meet regularly for the purpose of informal sharing of concerns on trends and developments in commodity markets as well as the sharing of market surveillance and enforcement approaches.

IOSCO's transparency and supervisory recommendations were endorsed by the G-20 Leaders in Pittsburgh in September 2009, who called for the publication of complete, accurate and timely data on oil market production, consumption, refining and stock levels, as appropriate on a regular basis, and the implementation of the 2009 IOSCO Task Force Report recommendations, including the collection by relevant regulators of data on large concentrations of trader positions in oil in commodity futures markets, the collection of related data on OTC markets, the publication of more detailed and aggregated data and steps to combat market manipulation[25].

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24 The term *related commodity market* refers broadly to the cash commodity that underlies the futures contract, as well as positions in privately negotiated transactions that are not traded on a regulated exchange (e.g. forward contracts, swaps, options and other structured products) involving the same commodity. The purpose of enhancing the transparency of related information is to assist in identifying market abuses in the regulated futures market. Correspondingly the term "underlying" commodity market refers solely to the physical/cash market.

25 *See* Paragraph 28, G-20 Pittsburgh Leaders' Statement on Energy and Climate Change http://www.pittsburghsummit.gov/mediacenter/129639.htm

The Task Force's June 2010 Report revealed a high degree of compliance by Task Force members with those recommendations[26].

[26] A majority of members monitor large concentrations, have the authority to order reductions in positions, and have authority to collect information on related OTC and cash market positions. In instances where authority is lacking, members are reviewing steps to request such additional authority. All Task Force members have the authority to share surveillance information, as well as powers to discipline exchange members and non members that engage in abusive trading.

Appendix II Contract Design as a means to promote Financial Oil Market Integrity

The critical role that underlying cash market prices play in the proper design of futures markets was thoroughly examined in the *Tokyo Communiqué's* Guidance *on Standards of Best Practice for the Design and/or Review of Commodity Contracts (contract design guidance).*[27] The contract design guidance set out the following standards of best practice that should be taken into consideration by market authorities in the design and/or review of commodity contracts:

- ***Accountability:*** *the competent market authority should establish a clear framework as to design and review criteria or procedures. Market authorities should be accountable for compliance with statutory and/or self-regulatory standards and should retain powers to address and where necessary to vary the provisions of existing contracts which produce manipulative or disorderly conditions. At a minimum a market authority with governmental powers should have legal or statutory powers to address contract provisions which produce manipulative or disorderly conditions;*

- ***Economic Utility:*** *contracts should meet the risk management needs of potential users and/or promote price discovery of the underlying commodity;*

- ***Correlation with Cash Market:*** *contract terms and conditions generally should, to the extent possible, reflect the operation of the underlying cash market and avoid impediments to delivery;*

- ***Settlement and Delivery Reliability:*** *settlement and delivery procedures should reflect the underlying cash market and promote price convergence;*

- ***Responsiveness:*** *the views of potential market users should be taken into account in designing commodity contracts; and*

- ***Transparency:*** *information concerning the contract's terms and conditions, as well as other relevant information concerning delivery and pricing, should be readily available to market authorities and to market users.*

The contract design guidance's discussion of "correlation with cash market" and "settlement and delivery reliability" makes clear the importance that accurate cash market prices play in commodity futures contracts: [28]

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[27] Tokyo Communiqué is available at:

http://www.cftc.gov/ucm/groups/public/@internationalaffairs/documents/file/oia_tokyorpt.pdf

http://www.meti.go.jp/policy/commerce/intl/tkyc.pdf

[28] *See* Tokyo Communiqué Design Guidance at pp. 15-19.

http://www.cftc.gov/ucm/groups/public/@internationalaffairs/documents/file/oia_tokyorpt.pdf

http://www.meti.go.jp/policy/commerce/intl/tkyc.pdf

The price of a futures contract at expiration should reflect the value of the underlying cash commodity as specified in the terms of the futures contract, plus or minus the costs associated with making or taking delivery. For physical delivery contracts, the possibility of delivery is the market force that usually causes convergence of cash and futures markets at expiration. Futures markets increasingly become susceptible to nonconvergence of cash and commodity prices, price disorder or manipulation when there are impediments to making or taking delivery.

Such impediments may be related to the inherent nature of the commodity (size of deliverable supply or seasonality of the commodity) or to the mechanics of the delivery process (e.g., transportation requirements, costs of inspection).

A high correlation between cash market prices and futures market prices may be achieved by designing the futures contract with terms and conditions which conform to the prevailing cash market commercial practices of the commodity underlying the futures contract. Accordingly, commodity contracts generally should, to the extent possible, be designed to conform to prevailing cash market commercial practices and to avoid impediments to delivery in order to reduce the likelihood of nonconvergence of cash and commodity prices, manipulation or a disorderly market. Deviations from cash market practice (which may at times be necessary) should be analyzed in light of their likely impact on orderly trading and price convergence. Market authorities should consider, without limitation, the following cash market characteristics in designing and/or reviewing commodity contracts:

1. *Size and structure of the cash market;*

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

3. *Extent of distribution (dispersal) of production and consumption of the cash commodity among producers, merchants and consumers;*

4. *Adequacy, nature and availability of supply of the cash commodity;*

5. *Quality or grade of cash commodity;*

6. *Movement or flow of cash commodity;*

7. *Liquidity of the cash market;*

8. *The cash pricing system including transparency, availability and frequency of cash pricing;*

9. *Price volatility; and*

10. *The existence of price controls, embargoes or other regulation or controls affecting the price or supply of the cash market commodity.*

The design guidance's discussion of "settlement and delivery reliability" provides that:

Whether settlement is by cash or by physical delivery, the settlement procedures should reflect the underlying cash market to promote reliable pricing relationships and cash/futures price convergence and to ensure that the contract is not readily susceptible to manipulation.

1. *Cash settlement*
   For contracts which are cash settled, considerations should include an analysis of the reliability of the cash commodity reference price on which pricing of the contract is based, public availability and timeliness of pricing information, liquidity of the cash market and the potential for price manipulation or distortion of the price used for cash settlement.

2. *Physical delivery*
   For contracts calling for delivery of the underlying product, considerations should include 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, shipping).