

Functioning and Oversight of Oil Price Reporting Agencies

Consultation Report



OICU-IOSCO

**TECHNICAL COMMITTEE
OF THE
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS**

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This paper is for public consultation purposes only. It has not been approved for any other purpose by the IOSCO Technical Committee or any of its members.

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Foreword

The International Organization of Securities Commissions' (IOSCO) Technical Committee (TC) has published this Consultation Report as part of its objective of answering the mandate of the G20 Leaders' Cannes Summit Final Declaration "to produce recommendations, in collaboration with IEA, IEF and OPEC¹, on the functioning and oversight of oil price reporting agencies". This Consultation Report is prepared by the IOSCO Task Force on Commodity Futures Markets (Task Force). IOSCO seeks the views of stakeholders on the questions and potential recommendations posed in this report to inform its final proposals to G20.

We seek full responses with as much supporting information and explanation as stakeholders consider appropriate. We request responses by Friday 30 March 2012. These responses will be considered in the preparation of a final report to be prepared by IOSCO, in collaboration with the IEA, IEF and OPEC, and submitted to the G20 as requested by the G20 in its Cannes statement.

How to Submit Comments

Comments may be submitted by one of the three following methods **on or before Friday 30 March 2012**. To help us process and review your comments more efficiently, please use only one method.

Important: All comments will be made available publicly, unless anonymity is specifically requested. Comments will be converted to PDF format and posted on the IOSCO website. Personal identifying information will not be edited from submissions.

1. Email

- Send comments to price-reporting@iosco.org;
- The subject line of your message must indicate *Functioning and Oversight of Oil Price Reporting Agencies*.
- If you attach a document, indicate the software used (e.g., WordPerfect, Microsoft WORD, ASCII text, etc) to create the attachment.
- Do not submit attachments as HTML, PDF, GIFG, TIFF, PIF, ZIP or EXE files.

2. Facsimile Transmission

Send by facsimile transmission using the following fax number: + 34 (91) 555 93 68.

3. Paper

Send 3 copies of your paper comment letter to:

¹ IEA, IEF and OPEC are the International Energy Agency, the International Energy Forum and the Organisation of Petroleum Exporting Countries, respectively.

Ms. Yukako Fujioka
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28006 Madrid
Spain

Your comment letter should indicate prominently that it is a “*Public Comment on Functioning and Oversight of Oil Price Reporting Agencies.*”

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Chapter 1 — Executive Summary

In the 2011 G20 Cannes Summit Final Declaration², the G20 Leaders stated:

“Recognising the role of Price Reporting Agencies for the proper functioning of oil markets, we ask IOSCO, in collaboration with the IEF, the IEA and OPEC, to prepare recommendations to improve their functioning and oversight to our Finance Ministers by mid-2012”.

This report is an IOSCO consultation which is intended to inform IOSCO’s response to the G20 Leaders’ request. IOSCO seeks the views of stakeholders on issues which it considers to be significant arising from the role and operation of oil price reporting agencies (PRAs).

The questions posed for consultation build on issues that were identified in the report of the international organisations³ and on matters of which IOSCO is aware from its discharge of its regulatory functions in relation to oil derivatives markets.

IOSCO will submit a final report to the G20 in answer to the G20 Leaders’ mandate and this will reflect IOSCO’s collaboration with the IEA, IEF and OPEC and the views of those organisations.

The PRA-assessed benchmark oil prices are widely used as references for transactions in significant numbers of physical oil markets, exchanges, clearing houses and over the counter (OTC) oil derivatives contracts, making these prices highly significant to the functioning of these markets. The activities performed by oil PRAs have, accordingly, a high impact on oil derivatives markets and to broader financial markets and the global economy.

Given the importance of PRAs and their function, it is critical that their arrangements governing how they operate and how they assess prices are appropriately framed and provide for sufficient safeguards to ensure the integrity of the price assessment function. In this report IOSCO considers, first, the governance of PRAs including consideration of the ownership of oil PRAs, their board and executive management structures, how they manage conflicts of interest, their complaints handling procedures, and their systems and controls. Secondly, IOSCO will consider the impact of the current functions of the PRAs on price transparency in the physical and derivative oil markets. The report asks whether current arrangements should be enhanced and if so how.

Current governance arrangements, however well formed, may only have limited effect if there is no recourse to an appropriate independent third party. Throughout this report comparison is made between the form of accountability for PRAs and for regulated financial entities, whose activities are generally subject to a form of accountability to a public authority.

IOSCO is also aware of views amongst stakeholders that PRAs are in a position to influence market development through the changes they propose to benchmarks. Comments from

² See *Cannes Summit Final Declaration*, G20, 3-4 November 2011, available at <http://www.g20-g8.com/g8-g20/g20/english/for-the-press/news-releases/cannes-summit-final-declaration.1557.html>.

³ See *Oil Price Reporting Agencies - Report by IEA, IEF, OPEC and IOSCO to G20 Finance Ministers*, IOSCO, 14 November 2011 available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD364.pdf>.

stakeholders indicate that in the absence of a formalised mechanism for the development of oil price assessments and in the absence of public accountability, PRAs have filled the void by taking on these roles themselves. IOSCO seeks clarification and substantiation of these views and asks for suggestions on whether this is appropriate and what alternatives might be more effective.

Notwithstanding the importance and impact of their function, PRAs are currently subject to no form of specific independent third party accountability to public authorities. IOSCO asks whether self governance for PRAs continues to be appropriate and if not, requests comments on a range of possible options for developing a form of oversight for PRAs.

Request for Responses

IOSCO is seeking the views of as wide a range of stakeholders as possible in response to the questions posed in this document. We seek full responses with as much supporting information and explanation as stakeholders consider appropriate. We request responses by Friday 30 March 2012. These responses will be considered in the preparation of a final report to be prepared by IOSCO, in collaboration with the IEA, IEF and OPEC, and submitted to the G20 as requested by the G20 in its Cannes statement.

Chapter 2 – Introduction

This Report has been prepared by the Technical Committee Task Force on Commodity Futures Markets (Task Force). The Report represents a key step by the Task Force to answer the call of the G20 Leaders' Cannes Summit Final Declaration⁴ relating to oil PRAs for "...IOSCO, in collaboration with the IEF, the IEA and OPEC, to prepare recommendations to improve their functioning and oversight to our Finance Ministers by mid-2012".

Background to the IOSCO Task Force

The IOSCO Technical Committee created the Task Force in 2008 in response to global concerns, including those expressed by the G8 Finance Ministers, concerning oil price volatility. The Task Force has proceeded against this background to produce recommendations which are intended to improve the efficiency and functioning of commodities markets.

Since IOSCO formed the Task Force, its primary focus in this area, given the remit of its derivatives regulator member authorities, has been on commodity derivatives markets, i.e. exchange-traded and OTC commodity derivatives. However, IOSCO has also commented on and produced recommendations which have a bearing on physical markets, since physical commodity and commodity derivatives markets are closely linked and operate with mutual dependency.

The Task Force's remit covers all commodity derivatives. However, given its significance to the global and to national economies, the Task Force has focused on oil derivatives markets, and hence physical oil markets. This attention to oil markets has been both at IOSCO's own determination, but also in response to direction from the G20.

Overview of IOSCO's work on Oil PRAs

Recognising the role of oil PRAs as collators of information on oil prices transacted in the physical and derivative markets and publishers of benchmark oil prices, IOSCO has already made recommendations in relation to PRAs themselves, as well as to regulated markets and their use of the prices reported by PRAs. In March 2009⁵, IOSCO recommended that "*Futures market regulators should encourage private organisations that collect relevant fundamental commodity information to adopt best practices and should evaluate what improvements are appropriate to enhance fundamental cash market data and develop recommendations for improvements.*"

In June 2010⁶ IOSCO recommended that a physical markets agency should lead a study on the functioning and impact of PRAs, a recommendation it repeated in November 2010⁷

⁴ See *Cannes Summit Final Declaration*, G20, 3-4 November 2011, supra fn 1.

⁵ See *Task Force on Commodity Futures Markets, Final Report*, Report of the Technical Committee of IOSCO, March 2009, available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD285.pdf>.

⁶ See *Task Force on Commodity Futures Market, Report to G-20*, Report of the Technical Committee of IOSCO, 23 Jun 2010, available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD324.pdf>.

⁷ OR08/10 *Task Force on Commodity Futures Markets Report to the G-20*, Report of the Technical Committee of IOSCO01 Nov 2010, available at

which, as discussed below, was taken up by the G20. IOSCO's recommendation was based on its continued concern for the efficient functioning and transparency of the physical oil, as well as oil derivatives, markets. This concern was part of a comprehensive and integrated policy response to the then recent behaviour of oil trading markets.

Most recently, in IOSCO's *Principles for the Supervision and Regulation of Commodity Derivatives Markets*⁸, published in September 2011, it was noted in the context of contract design that

“... information provided by third-party price reporting agencies (PRAs) plays a critical role with regard to the design of commodity derivatives contracts and as a basis for the floating price component for settlement of OTC commodity derivatives contracts.”

PRA benchmark prices are referenced by many key exchange-traded commodity derivatives contracts, clearing platforms and by a very significant number of OTC commodity derivative contracts. As such, PRAs have significant impact on the overall functioning of commodity derivatives markets, on the price discovery process and on risk management. They may also have significant systemic impact given the importance of oil to the global economy. These factors are central to IOSCO's continued attention on PRAs.

Notwithstanding their clear importance, PRAs and their activities relating to price assessments in oil markets remain subject to no form of regulatory scrutiny or accountability beyond that which is expected of them as normal commercial enterprises.

G20 Mandates on Oil PRAs

The G20 has identified oil PRAs as an important area for consideration in its overall policy reform agenda relating to oil markets. In its Seoul Summit Leaders' Declaration of November 2010⁹, the G20 Leaders stated:

“We also request the IEF, IEA, OPEC and IOSCO to produce a joint report, by the April 2011 Finance Ministers' meeting, on how the oil spot market prices are assessed by oil price reporting agencies and how this affects the transparency and functioning of oil markets.”

The IEA, IEF, OPEC and IOSCO (International Organisations or IOs) worked together to respond to this request, resulting in a joint report which was published in November 2011 (IOs report)¹⁰.

<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD340.pdf>.

⁸ See FR07/11 *Principles for the Regulation and Supervision of Commodity Derivatives Markets*, Report of the Technical Committee of IOSCO, 15 Sep 2011, available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD358.pdf>.

⁹ See *The G20 Seoul Summit Leaders' Declaration*, G20, November 11 – 12, 2010, available at <http://www.g20.org/images/stories/docs/eng/seoul.pdf>

¹⁰ See *Oil Price Reporting Agencies - Report by IEA, IEF, OPEC and IOSCO to G20 Finance Ministers*, IOSCO, November 2011, supra fn 2.

The IO's report gave a largely factual background to current PRA operations in the oil markets and the methodologies used by PRAs to report data, but did not make significant comment on PRAs' market impact. However, the report did raise issues and concerns that warrant further consultation with market participants. The IO's report also did not give recommendations to the G20 of possible policy directions which could enhance PRA functioning and mitigate any risks arising from PRA market impact. Accordingly, recognising these as logical next steps, in its Cannes Summit Final Declaration, the G20 Leaders stated:

“Recognising the role of Price Reporting Agencies for the proper functioning of oil markets, we ask IOSCO, in collaboration with the IEF, the IEA and OPEC, to prepare recommendations to improve their functioning and oversight to our Finance Ministers by mid-2012.”

Process for Responding to the G20 Mandate

To answer the G20 Leaders' latest request IOSCO intends to build on the work which led to the IOs report and to take account of its own experience with oil PRAs, accrued from its work supervising oil derivatives markets.

IOSCO will also leverage its experience and knowledge of supervising regulated financial entities and particularly those where there may be valuable parallels to either the structure or function of PRAs. These parallels are useful for comparison in critiquing and commenting on current arrangements relating to PRAs and how they may be improved upon. As an example, IOSCO notes that there are similarities between PRA functioning and that of regulated financial market infrastructure including trading platforms, clearing houses, credit rating agencies, regulated market arrangers, information service providers and financial market participants. However, IOSCO is cognisant that PRAs perform a unique role and that any consideration of them should be based primarily on their functioning alone. IOSCO is also aware that not all entities that perform a price reporting function are appropriately described as PRAs since the function is carried out by a diverse range of organisations.

IOSCO recognises the importance of stakeholders' views, given that there are potentially a very wide range of stakeholders with interest in the G20's mandate and in the functioning and impact of oil PRAs. Accordingly, IOSCO is publishing this Consultation Report to set out its current thinking about the G20's mandate and to seek input from stakeholders on the issues raised in this Consultation Report, all with a view to inform IOSCO's final report to the G20.

As part of this process, IOSCO will continue its discussions with the IEA, IEF and OPEC, in the spirit of collaboration that the G20 has requested. Where the IOs are in agreement on policy recommendations, these will be presented as consensual recommendations to the G20. However, this G20 request has been directed to IOSCO and therefore in the interests of ensuring that material output is made, IOSCO will put forward all of its relevant views and recommendations to the G20, giving due indication to the views of other IOs, including indicating areas of disagreement.

Chapter 3 –Areas for potential recommendations to the G20 about oil PRAs

The G20 has given a general direction for recommendations for oversight and to improve the functioning of oil PRAs. Having identified certain issues relating to PRA operation, both in the IO's Report and in the experience of IOSCO members' own market surveillance, this Consultation Report considers a number of areas, detailed below, from which recommendations may arise.

Impact of Oil PRA Benchmark Prices on physical and financial markets

PRA benchmark prices are referenced for a range of oil derivatives contracts. These include OTC bilateral transactions, OTC transactions offered by market platform clearing services and regulated exchange-traded cash settled contracts. Other than for contracts traded on regulated exchanges, it is difficult to obtain definitive data on the volume and size of transactions which reference PRA benchmarks. While the consultative research underlying the IOs report to the G20 shows that some firms are reluctant to share their trading volumes, IOSCO members' market surveillance indicates that the number of transactions referencing PRA benchmarks is significant and diverse.

Data on exchange-traded benchmarks is customarily published by exchanges. There is a considerable trading volume in this space alone which reference PRA benchmark prices. One particular example is the ICE Futures Europe Brent Futures Contract, which references in its cash-settlement procedure a basket of PRA produced prices. ICE Futures Europe Brent Futures is, by volume, the second most widely used oil futures exchange-traded benchmark globally. A further example is the Tokyo Commodity Exchange's Crude Oil futures contract which is settled on the Yen-based monthly average value of Dubai and Oman crudes, based on prices reported by a PRA.

Collation of data on OTC contracts is currently unavailable. However, the reporting of OTC derivatives to trade repositories will be required by financial legislation reform in many jurisdictions¹¹. It is clear that PRA benchmarks are widely referenced in OTC derivatives contracts, indeed relevant sections of the industry standard International Swaps and Derivatives Association (ISDA) Master Agreement make specific provision for pricing references to PRA benchmarks.

Additionally, PRA-generated benchmark prices are written into many long-term physical market contracts as reference prices. Many of these contracts are for the supply of oil to consumers for periods as long as twenty years or more and are, accordingly, of great importance to those contracting parties.

Against this background, the integrity and availability of PRA benchmarks is clearly important. PRA benchmarks need to have satisfactory protections against potential

¹¹ As examples, in Europe the proposed Regulation on OTC derivatives, central counterparties and trade repositories at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0484:FIN:EN:PDF> and in the United States the Dodd-Frank Wall Street Reform and Consumer Protection Act <http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf>

manipulation and be generated by processes which are governed by appropriate systems and controls, backed by suitable standards of corporate governance.

Question for Comment

Q1 Are you or your company currently subscribers to the services of PRA(s)? If so, how would you rate the overall quality of the work being carried out by the PRA(s)?

Q2 Please provide information on the impact of PRAs on physical oil and oil derivatives markets. Please support your comments with data on the volume and value of the related physical oil and oil derivatives business you are aware of, which is dependent on PRA benchmark prices (where possible broken down into the following categories: OTC; OTC cleared; or exchange-traded)

Significance of Methodologies Used by PRAs

There is significant reference by oil derivatives market participants to PRA-generated prices as discussed previously. However, it is an important question whether this implies that the methodologies used by PRAs have an impact on the physical oil and oil derivative markets.

The potential impact may be judged by the potential consequences of methodological errors in the construction of a PRA benchmark price. Some argue that these issues can be mitigated. For instance, in most markets more than one PRA price is available for each particular grade of oil. Also, key contracts can make provisions for alternative arrangements in the absence of a reliable or any PRA-generated price. However, the ease with which market participants are able to identify a methodological error and find alternatives is open to debate.

Additionally, the decision or actions of a PRA may potentially have a broad market impact. For instance, the decision by a PRA to exclude a particular participant from its assessment process is likely to become known in the market and to cause other participants and stakeholders to question why that decision was made. Associated speculation as to the reasons for the suspension may lead to wider concerns arising about the standing of that participant, particularly if market conditions suggest that such concerns may have substance. It may be logical for a PRA to exclude certain counterparties from the PRA price series, but having a transparent process which gives stakeholders confidence that the decision is based on a clear rationale and appropriately justified is essential to protect market confidence.

PRAs have been criticised for imposing the market methodologies that influence the way the industry trades. That is, traders who wish their transactions to be included in an assessment methodology must deal in a manner and time that meets the particular methodology.¹² The integrity of the price assessment methodology is therefore of critical importance. A further issue for PRAs is that they can only be aware of transactions which are reported to them and the potential for participants to report selectively so as to attempt to manipulate prices cannot be discounted. This risk, if crystallised, has the potential therefore to bring into sharp focus the impact of PRAs on both physical oil and by read-through, oil derivatives markets.

¹² See page 5 *Oil Price Reporting Agencies - Report by IEA, IEF, OPEC and IOSCO to G20 Finance Ministers*, IOSCO, November 2011, supra fn 2.

Questions for Comment

- Q3 What are the impacts of PRA processes on oil trading markets, physical and/or derivatives? In your answer please comment on the quality of PRA processes, their strengths, as well as the potential impacts of any perceived weaknesses.*
- Q4 Do you consider PRAs to have potential systemic impact on the financial system? Please give reasons for your answers.*
- Q5 What are your views regarding PRA price methodologies, including your ability to identify methodological errors? Do you consider that mechanisms or procedures exist to address any such concerns and are they adequate? Have PRAs demonstrated responsiveness in updating their methodologies to reflect market development?*

Impact of voluntary reporting to PRAs

As a general matter there is no obligation on any market participant to report on concluded transactions to PRAs. Market participants may consider it desirable to report transactions to PRAs as a way of ensuring that the price of transactions they have entered in to have a bearing on the PRA-published benchmark price. The reporting of legitimate transactions to PRAs brings beneficial transparency to markets.

There is a risk that a PRA's benchmark price can be manipulated by the submission of false prices or by over or understating the volume transacted. It is very important, as described above, that the processes employed by PRAs mitigate this risk. As mentioned, a further risk is the potential for market participants to selectively report transactions in an attempt to manipulate prices, i.e. to submit only those prices that will have an impact on PRA benchmarks in a particular direction. This practice may potentially influence the physical benchmark price and, by extension, the PRA benchmark price referenced in oil derivatives contracts.

PRAs do not contractually require the market participants that participate in their price formation processes to submit all of their transactions. It is of key importance therefore that PRAs' processes take account of the potential for selective reporting by participants in order to influence prices and identify where submitted prices are trending away from what they assess to be real market value.

This raises the issue of the number of transactions which underlie PRA-assessed benchmark prices. Stakeholders have commented to IOSCO that the number of completed transactions reported to a PRA for inclusion in its benchmark price assessment is low in many cases. Specifically, the number of transactions in certain benchmark assessments can often be less than five and not infrequently there are no prices submitted to a particular PRA on which it can base its assessment. In such cases, PRAs have alternative procedures for making an assessment. For example, where there are no deals done the reporters must use their own judgment to interpolate, extrapolate and arrive at price assessments that the trading community would deem objectively reasonable.¹³ In such circumstances the PRA's view of the real market price may be easily distorted by selective reporting.

¹³ See page 9 *Oil Price Reporting Agencies - Report by IEA, IEF, OPEC and IOSCO to G20 Finance Ministers*, IOSCO, November 2011, supra fn 2.

Questions for Comment

- Q6 Does the voluntary reporting of transactions used in certain PRA assessments pose risks to the price assessment process? If so, how should these risks be mitigated? Would it be beneficial if reporting of transactions to PRAs were mandated (contractually or by legislation)?*
- Q7 Do low numbers of transactions used in certain PRA assessments pose risks to the price assessment process? If so, what crude grades and markets do you see affected by this? What is considered to be a 'low' number? How should any such risks be mitigated?*
- Q8 Taking account of existing PRA procedures to obtain information on which to base their assessment when no transactions have been submitted, are there any other approaches that may produce their benchmark prices in the absence of liquidity?*

Accountability of PRAs

PRAs are accountable to public authorities as corporations in as much as requirements placed on such corporations will apply to them. These requirements will differ between PRAs, inevitably because of jurisdictional differences but also because of corporate status. Amongst the leading PRAs are both privately owned companies and subsidiaries of listed companies, to which differing accountability applies.

Additionally, PRAs are accountable to their users, and we will discuss competitive considerations in a later section. However, this is a very different form of accountability to government oversight or regulation.

If there is to be potential oversight or further accountability to the public of PRAs, there needs to be a set of objectives and a form of operation. IOSCO considers there are key areas forming part of the current oversight of financial entities which could form the basis for recommendations on the oversight of PRAs.

A significant part of the oversight of financial entities focuses on their internal operations and external “conduct of business” activities that affect the users of their services. The aims of this type of oversight include ensuring a transparent operation that provides users with confidence that pricing decisions are subject to clear and demonstrable processes with appropriate safeguards in place. As we go on to discuss, these objectives may also be appropriate to PRAs.

Questions for Comment

- Q9 Are there any issues regarding PRAs that concern you from a public accountability perspective?*
- Q10 Do you consider the function performed by PRAs to require a form of public oversight of PRAs? If so, which PRA activities should be subject to a form of public oversight and why?*

Governance of Oil PRAs

PRAs are privately owned companies or subsidiaries of listed companies that are not subject to independent third party oversight or scrutiny. As such, their governance arrangements are individually designed to satisfy the external accountability applicable to them as general commercial enterprises. It should be instructive, therefore, to make comparisons with the external oversight of financial entities. Financial entities have to satisfy regulatory requirements set out in legislation and regulatory guidance when framing their system and control arrangements. In this section we will compare the standards regulated financials have to comply with to the current arrangements for PRAs.

Ownership

Some PRAs are privately owned and subject to different forms of ownership, whilst other leading PRAs are entities that form part of wider listed groups. It is possible that a PRA may become owned by individuals or groups of its own customers or participants. Without any form of public oversight, there is no external body to insist that appropriate safeguards are put in place if a PRA should become owned in significant part by its users. In contrast, regulated financial entities within groups are often required to agree to appropriate safeguards to ensure regulatory objectives are met.

Question for Comment

Q11 Please detail any concerns you may have about current ownership of PRAs in particular with regard to possible conflicts of interest.

Board Structure

The standards of overall governance of PRA business units vary according to the jurisdiction in which they are based and their corporate status, i.e. whether they are privately owned companies or subsidiaries of listed groups. Amongst PRAs there are entities whose price reporting functions report immediately to the highest level entity within the corporate group whilst others have several layers of corporate structure between the two. The structure of the Board (or Board equivalent) of PRAs differ, for example, in terms of the proportion of non-executive directors and independent directors.

In contrast, in order to ensure that regulated financial entities meet relevant legislative and regulatory suitability requirements, these entities typically need to demonstrate to their regulator that their governing body has sufficient experience and skills to direct the business. Also, they must demonstrate that board members are *fit and proper* and that there will be an appropriate level of challenge to the entity's executive. Additionally, the regulator may have a veto over board appointments if it considers that candidates are unlikely to meet the relevant requirements. The presence of general market requirements, as well as a regulator to assess whether accountability requirements are met, therefore provides an additional level of oversight beyond what PRAs are generally subject.

Questions for Comment

Q12 Do you have any concerns regarding the current corporate governance standards of PRAs? If so, what are the improvements that you believe are needed?

Q13 Do PRAs need to be subject to standards of corporate governance that are equivalent to the standards to which regulated financial entities are subject? Please elaborate.

Systems and controls over methodologies and internal policies

PRAs have different forms of systems and controls in place to manage their business. They generally implement systems and controls through their Board and Executive Committees who regularly review analysis and metrics that monitor financial performance, compliance and the quality of PRA activities.

PRAs generally employ compliance officers at a local or global level, depending on whether they are part of a wider group. PRA compliance officers run a programme of reviews to check for compliance with internal methodologies and policies. Reviews are also conducted of individual teams including an analysis of pricing and processes, again to check adherence to the methodologies.

PRAs that belong to a group of entities may utilise their group audit functions and also usually have a local internal audit function. Whichever audit function is used, it will review adherence to editorial methodologies and specifications. Results of audits are reported to editorial line management, senior management and group heads. PRAs also undertake annual financial audits to comply with relevant corporate legislation.

It is key that these control functions are of appropriate quality and have sufficient independence from the functions of the business over which they exercise control and challenge. Appropriate reporting lines and seniority of staff are required to ensure that the control functions within PRAs can operate credibly. Any concerns senior staff identify should receive appropriate backing from the PRA's governing entity so that associated risks can be satisfactorily mitigated and procedural weaknesses corrected.

In contrast, regulated financial entities are typically required to ensure they have adequate systems in place and controls appropriate for the nature and scale of their business. The relevant regulator is required to review these systems and controls to determine the risk to the wider derivatives markets. An example for comparison is that regulated trading platforms typically meet these requirements by organising a range of monitoring processes, reviews and committees. These include risk and audit committees (with appropriate membership), external audits, ex ante and ex post market monitoring processes, and establishing rules that are transparent and accessible to members of the exchange and market participants. By contrast PRAs do not have any requirements to demonstrate to a regulator that they have adequate systems and controls.

The importance of appropriate systems and controls and presence of sufficient checks and balances is especially pertinent in PRA benchmark determinations when, as part of their published methodologies, they use judgement. This occurs where numerous trade reports have been submitted and it is necessary to assess a representative benchmark price from them. However, as discussed above, often in certain PRA benchmark grades the number of submitted transactions may be very small or indeed there may be no transactions at all. In these circumstances PRAs typically fall back on a range of information sources, including taking the views of a selection of market participants. Although it is particularly important that appropriate processes are in place to ensure that the participants selected are reliable and

representative of the wider stakeholder base. It is also important that, whatever the origin of the data, PRAs have well documented and audited procedures.

Questions for Comment

Q14 Do you have any concerns as to the robustness of the systems and controls in place at PRAs as they relate to the integrity of the processes used to construct price series or indices? Please explain.

Q15 Which authority, if any, should establish a set of principles for the appropriate level of systems and controls within a PRA and in particular as they relate to PRA benchmark methodologies? Would this sufficiently address any concerns you may have and, if so, how?

Q16 Should PRAs as a general matter be subject to a specified external audit of individual operations or processes, the results of which could be published demonstrating standards of compliance with relevant rules? Would PRAs need to be held to account for such an audit and, if so, which organisations would be best placed to carry out such an audit? What are the benefits and risks?

Complaints handling

Unlike regulated financial services firms, PRAs' complaints procedures are not subject to regulatory oversight. How PRAs handle transaction submissions and how these submissions are incorporated in the price assessment calculations where users are dissatisfied is of high importance. Some PRAs appoint senior report editors to manage complaints in the first instance, in an attempt to ensure price reporters do not lead complaint investigations. In other cases complaints and inquiries are handled by front-line staff in collaboration with other appropriate teams. The complaints are then notified and reported to direct managers. If complainants are dissatisfied with the handling of their complaint, it would be escalated to senior management as a final opportunity for resolution. In some instance, disputes can also be reviewed by compliance departments that have reporting lines to the CEO, or groups that are different from price reporting teams. However, whilst some PRAs have relatively formal procedures, we are not aware of any PRA which has independent dispute resolutions procedures to an external party or independent recourse for complainants.

Regulated financial entities, however, are typically required to have effective arrangements for investigation and resolution of complaints. Such arrangements must include a fair and impartial investigation and offer the complainant the possibility for appeal or escalation. Such process could include access to an ombudsman, provide for referral to an arbitration process or escalation to a regulatory tribunal. Furthermore, the results of investigations are reported back to the regulated entity and complainant. The independent organisation or person reviewing complaints will typically be remunerated by the entity. Accordingly, the person or organisation has to be of sufficient seniority and repute that the risk of bias arising from the source of their remuneration is mitigated by the need for them to protect their reputation. The recourse and processing of a complaint to an independent investigator is not an option complainants have under current PRA complaints handling procedures.

The outcome of resolved complaints will not typically be published by PRAs, so there is little transparency associated with the process and opportunity for stakeholders to learn from

published outcomes. This contrasts with processes in the financial regulatory sphere where the results of completed complaints or investigation processes are often shared with the regulator and in many cases also to stakeholders by way of a public statement.

Questions for Comment

Q17 Should PRAs be required to incorporate into their rules, if absent, a formal complaints procedure. If so, please explain what would be your preference in terms of procedure or process?

Q18 Should disputes be resolved by an appropriate third party as a matter of course? Please explain the benefits and risks.

Q19 Should such a formal complaints procedure necessitate greater transparency in the handling and resolution of complaints by PRAs, for example by requiring transparency of the complaints process and publication of decisions and the rationale for them?

Conflicts of interest

PRAs use a range of measures to manage conflicts of interest and help protect the integrity of their price reporting. For example, they conduct employee interviews to check adherence to the PRA's conflict of interest policies. These policies require staff to exercise due diligence and this requires them to declare shareholdings or ownerships in energy and commodity companies. Additionally, PRA staff can be prohibited from dealing or trading in shares or commodities in energy and commodity sectors. Staff failing to follow such policies may face disciplinary action. PRAs can also ring fence their price reporting activities away from those that could compromise the accuracy of the prices they report, such as sales and business and commercial development activities.

Further methods employed by PRAs include internal code of ethics agreements. These codes are designed to promote objective reporting. PRAs also rely on internal oversight by relevant managers and editors and public scrutiny by market participants and commentators who have access to their published methodologies. However, external stakeholders can only offer limited challenge as these methodologies are not externally audited.

As well as conflicts of interest from sources internal to a PRA, there is also significant potential for conflicts of interest arising from interaction with the external environment. Ownership by users has been discussed above. It is possible that in certain business segments revenue from subscribers is concentrated amongst a relatively small number of users who themselves submit the transaction information on which price assessments are based. This could be a source of commercial pressure to a PRA.

Amongst the PRAs are organisations that classify themselves as media organisations and provide other services including news reporting on markets for which the PRA produces benchmark prices. It is a risk that the PRA may come into possession of information which could influence the price assessment process and cause it to depart from its published methodology. Conversely, confidential transaction information should not be disclosed by the PRA's reporting function. It is important therefore that PRAs have processes to govern these risks.

Some regulated financial entities face many similar risks and are typically required to identify and manage conflicts of interest that could have adverse impacts on the markets. The systems and controls that the regulated financial entities have in place to manage these are typically assessed and require approval by their relevant regulator, both for impact on the business and on the markets. Critically, for PRAs there is no overseer of the processes they have developed, no assessor of the rigour and strength of the developed processes and no arbiter to which conflicts or disputes can be escalated. Potential conflicts of interest and impacts arising from them are very significant in price reporting and the absence of any governing authority over them leaves PRAs unsupported and subject to the commercial pressures from which these risks originate.

Question for Comment

Q20 Please describe concerns you may have relating to potential conflicts of interests affecting PRAs arising from revenue generation, media reporting, internal staff management or any other source. Has this had any impact on the price reporting function of PRAs and if so how?

Competition aspects attached to the PRA sector

Stakeholders have commented to IOSCO members about the extent to which there is meaningful competition between PRAs for individual benchmark markets. It is clear that PRAs are commercial enterprises which compete with one another for subscriptions to their publications and for market prominence. However, these stakeholder comments refer to the ability of users to transfer between PRAs competing benchmarks in individual markets.

The PRA market has developed such that for many individual benchmarks, there are in each case leading benchmarks around which users have coalesced. The result is that different PRAs have prominence in different markets. Users, which express discontent with a particular PRA, comment that they cannot simply change to another PRA benchmark since to do so would necessitate moving away from the current concentrated usage of the leading benchmark and thus expose the migrating user to an unwanted basis risk in that particular market. It appears, on the basis of these comments, that users believe they are forced to continue to suffer unsatisfactory decisions made by a particular PRA, since that is preferable to exposing themselves to basis risk in the market. Some of the contracts that reference PRA benchmark prices can have maturities of twenty years or more, so the implications of an inability to change from an unsatisfactory benchmark can be significant and long lasting.

Whilst there are some examples of users migrating simultaneously between PRA individual benchmarks, these appear to be relatively few. IOSCO acknowledges that the coalescence of usage and inertia to change also occurs around the many contracts listed on financial trading platforms. Financial trading platforms and activity is however largely distinguishable from PRA activity because of the presence of publicly mandated oversight and regulation of financial trading platforms.

Stakeholders have also stated that forming an *industry coalition* of multiple users to migrate between PRA benchmarks, thus moving the incumbent liquidity pool *en bloc*, is not possible

because there is no process for the oil industry¹⁴ to convene. Some stakeholders have stated that there is no prospect that any such process could be devised since, without independent oversight, it would immediately expose the cooperating companies to allegations of and probable investigation for price collusion, due to the sensitivity of oil prices.

Questions for Comment

Q21 Are there any undue obstacles that prevent market participants from adopting different sources for price references? Please explain.

Q22 If so, does this constitute a competitive concern for either individual PRA benchmarks or the PRA sector as a whole? Where appropriate, please refer to specific benchmarks.

Q23 If you have concerns about competition relating either to individual PRAs or to the PRA sector or around individual benchmarks, please comment on how you think these could be addressed.

Stakeholder representation

The lack of a forum for the oil industry to meet presents potential concerns outside the scope of this study, since it is likely that there are topics other than PRA decisions and alleged benchmark *monopoly* that the industry might usefully meet together to discuss. However, the development of trading terms to reflect evolving physical realities is an area which impacts how PRAs structure their benchmarks. It is an area where some stakeholders have commented that PRAs have stepped in to fill the oversight/regulatory vacuum and have acted to enable developments which may not otherwise have been possible.

Accordingly PRAs have in certain instances acted as a point around which the relevant section of the oil industry, i.e. those affected by a particular potential decision, can coalesce and through which change can be effected¹⁵. IOSCO is aware that these types of changes are often accomplished by PRAs in a consultative process with their subscribers and in to which non-subscribers can also input. PRAs may publish details of their consultation procedures, provide bilateral and group discussion fora and make decisions taking account of consultation responses. However, the terms of the consultation and how it will proceed are typically set unilaterally by the PRA and since it has no accountability to any independent oversight, stakeholders have sometimes expressed dissatisfaction that PRAs do not take account of consultation responses or effect change too quickly.

We recall also, as discussed above, that PRAs necessarily use judgement to take decisions on individual price assessments and on the suitability of submitted transactions. Certain stakeholders have commented that this power, together with the PRAs' role of effecting higher-level framework change, or conversely resisting change and acting as a brake on

¹⁴ *Oil industry* for these purposes encompasses potentially all wholesale stakeholders in oil production, consumption and trading, including financial market traders.

¹⁵ For example, in 2010 Platts proposed certain changes to its Dated Brent price assessment. See *Platts to adopt 25 day basis for Brent assessments - Enhancement reflects market evolution, will strengthen physical benchmark*, Platts, London - September 16, 2011, available at <http://www.platts.com/PressReleases/2011/091611>

market development (including that of alternate benchmarks), puts PRAs in a quasi-regulatory role for the oil trading markets to which their benchmarks have significance. Stakeholders have expressed the view that this gives the PRAs too much power in relation to those particular markets and that they are able to guide market standards often against what market users consider to be in those markets' best interests.

Given the public and systemic importance of both physical oil and oil derivatives trading it is important to question whether this *quasi-regulatory role*, if it has developed as these stakeholders contend, appropriately resides with unregulated enterprises which are not subject to statutorily governed accountability, or whether a form of specifically tailored public oversight should be put in place.

Questions for Comment

Q24 Is there a need for structural reforms that would provide a process or mechanism for increased stakeholder representation or input of views? Given the use of PRAs by the oil industry, what mechanism would be needed to alleviate concerns of collusion?

Q25 What should be included in the terms of reference or objectives of any such process? What are the benefits and risks?

Q26 Who, if any one, should provide any oversight for such a process?

Options for oversight

The range of potential approaches to PRA oversight may realistically lie between recommending a form of self regulation to recommending a direct governmental regulatory system for PRAs.

Self-regulation applies to various sectors in certain jurisdictions. It may in certain circumstances be a low cost option and can have efficiencies inherent in being designed and operated by those most familiar with the regulated activity. There is no independent accountability with self-regulation and as discussed this can serve to undermine it, either in effect, perception or both.

At the other end of the spectrum, setting up independent oil market regulators for physical oil markets, either focused exclusively on oil PRA activity or more broadly on the physical oil markets themselves, would have the benefits of providing dedicated authorities with a clear focus on physical oil markets. It would be important that there would be close cooperation arrangements with oil derivatives regulators to ensure coordinated supervision. Direct regulation of PRAs need not entail the creation of a new regulator. For example, legislation could grant powers to relevant physical market authorities. Where there are oil market authorities these will be ideally placed but, as most jurisdictions do not have oil market authorities, alternative energy market regulators such as those for gas and power markets which operate in many jurisdictions could be given the role. Alternatively, the authorities for oil derivatives regulation, which already have jurisdiction over oil derivatives trading, could have their remit extended to cover physical oil markets, with a specific focus on the activity of PRAs.

Increased authority for oil derivatives markets regulators, to cover PRAs could be implemented in a number of ways. Such as, in legislation obliging the PRAs to take responsibility for self-regulating certain of their functions, subject to oversight by a public authority against high-level standards. These could include governance, systems and controls, orderly operation and financial resources and would be designed to ensure that PRAs operate in a manner which ensures orderly and fair price discovery and an environment in which stakeholders can have confidence. Making the PRAs accountable to a public authority for these responsibilities would provide the essential element of recourse for PRA stakeholders which pure self-regulation cannot provide.

Statutory governmental market regulators could give greater scrutiny to the integrity of any third-party price series or indices that are referenced by a regulated derivatives contract. In this regard, oil derivatives market regulators are under an obligation to ensure the integrity of traded oil derivatives contracts and take action to address derivatives contract provisions which produce or are deemed likely to produce manipulative conditions. The IOSCO Assessment Methodology (2010) requires that a regulator be informed as to the types of securities and derivatives products traded on an exchange or trading system and that the regulator should review and approve the rules governing trading of the product where applicable.¹⁶ The recently adopted IOSCO *Principles for the Regulation and Supervision of Commodity Derivatives Markets*¹⁷ require market authorities – which may be an exchange, the statutory regulator or a Self Regulatory Organisation (SRO) – to retain powers to address provisions in contracts that produce, or are deemed likely to produce, manipulative or disorderly conditions. It follows that where a derivative contract is based on a price series or index that is constructed by a third party, the regulator’s review of the contract could focus on the integrity of that third party index.

Questions for Comment

Q27 If required, what would be appropriate models for oversight of PRAs, covering the options described above and potentially others you may consider appropriate? What are the potential benefits and risks, if any? What economic impact, if any, would there be?

Q28 Do you believe that a self-regulated PRA Code of Conduct could appropriately mitigate any risks or concerns you have about PRA governance? Please explain any concerns or identified risks and give reasons for your answer.

Q29 Would your view of the application of a Code of Conduct change if the PRAs were held to account for its application by a public authority? Please explain and, if appropriate, state which authority or authorities would be best placed to hold the PRAs to account. What, if any, are the potential benefits and risks?

¹⁶ See FR08/11 *Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation*, Report of IOSCO, 18 October 2011, available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD359.pdf>.

¹⁷ See Principle on Accountability, FR07/11 *Principles for the Regulation and Supervision of Commodity Derivatives Markets*, IOSCO, Sep 2011, supra fn 8..

- Q30 Should greater attention be focussed by all market authorities, namely exchanges, their governmental regulators and relevant SROs, on the reliability of price series and indexes that are constructed by oil PRAs? If “yes”, please comment on the objectives of and mechanisms for such greater involvement by these market authorities. If possible, please provide examples of financial instruments that raise price series/index reliability concerns.*
- Q31 Should IOSCO and any other relevant authorities develop for regulated markets and other trading facilities which use PRA benchmark prices in their derivatives contracts a set of specific criteria against which the suitability of PRA benchmarks should be assessed? If so, which criteria do you think should be included*