Standing Committee on

Commodity Futures Markets

Update to G20 Leaders on

IOSCO's Consultation on the Functioning and Oversight of Oil Price Reporting Agencies

TECHNICAL COMMITTEE
OF THE
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

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Introduction

The G20 Seoul Summit Leaders' Declaration on November 11 – 12, 2010, requested "the IEF, IEA, OPEC and IOSCO to produce a joint report on how the oil spot market prices are assessed by oil price reporting agencies ("PRAs") and how this affects the transparency and functioning of oil markets".

As a follow up to this report, in the 2011 G20 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*".

At its most recent meeting of the G20 Finance Ministers and Central Bank Governors in Washington, DC, the Final Communiqué stated, among other things:[1]

> *We look forward to the IOSCO progress report on the implementation of its Principles for the Regulation and Supervision of Commodities Derivatives Markets at our next meeting in November. We welcome the consultation by IOSCO on the functioning and oversight of price reporting agencies and look forward to an update on their emerging recommendations for leaders in Los Cabos.*

This report ("Status Report") describes IOSCO's actions to date on this subject and provides a preliminary indication of the areas of potential concern that will be the subject of continuing discussion relative to the development of forthcoming recommendations by IOSCO and the IOs.

IOSCO's Consultation on PRAs

On March 1, 2012, IOSCO published a consultation report ("Consultation Report"), [2] as part of its objective of answering the mandate of the G20 Leaders' Cannes Summit Final Declaration "to produce recommendations, in collaboration with the following international

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[1] Final Communiqué, Washington DC (April 2012) http://www.g20.utoronto.ca/2012/2012-120420-finance-en.html

[2] CR04/12 *Functioning and Oversight of Oil Price Reporting Agencies,* Report of the Technical Committee of IOSCO (March 2012) http://iosco.org/library/pubdocs/pdf/IOSCOPD375.pdf

organizations IEA, IEF and OPEC[3]on the functioning and oversight of oil price reporting agencies." The Consultation Report was prepared by the then IOSCO Task Force on Commodity Futures Markets ("Task Force"), now Standing Committee on Commodity Futures Markets ("Standing Committee"), as a means for IOSCO to obtain the views of stakeholders on the questions and potential recommendations posed in that report to inform its final proposals to G20[4]. The questions posed for consultation built upon issues that were identified in the report of the IOs and IOSCO in November 2011.[5]

The consultation period closed on March 30, 2012. On April 18 and 19, the Task Force held a meeting in Washington, DC to discuss the comments that were received. As part of that meeting, the Task Force met with the IOs and had a very helpful and informative exchange of views.

As made clear in the Consultation Report, PRA-assessed benchmark prices are widely used as references for transactions in a number of physical oil markets, exchanges, clearing houses and over-the-counter ("OTC") oil derivatives contracts, making these prices significant to the functioning of these markets. The activities performed by oil PRAs have, accordingly, an impact on physical oil markets, oil derivatives markets as well as on broader financial markets and the global economy. [6]

Accordingly, it is crucial that their arrangements governing how they operate and how they assess prices provide for sufficient safeguards to ensure the integrity of the price assessment function. Because of the importance of price integrity, and a number of technical and regulatory issues raised by PRAs, IOSCO intends to proceed in a deliberative manner so as to ensure a full consideration of these issues and a detailed discussion of any recommendations to be submitted to the G20.

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[3] IEA, IEF and OPEC are the International Energy Agency, the International Energy Forum and the Organisation of Petroleum Exporting Countries, respectively (the "International Organizations" or "IOs".

[4] *At its Annual Meeting in Beijing on 14/15th April 2012 IOSCO approved the conversion of the Task Force into the Standing Committee on Commodity Futures Markets. In this report the terms Standing Committee and Task Force (as defined above) are both used, as appropriate to the relevant reference*.

[5] *Oil Price Reporting Agencies – Report by the IEA, IEF, OPEC and IOSCO to the G20 Finance Ministers,* (November 2011) http://iosco.org/library/pubdocs/pdf/IOSCOPD364.pdf

[6] CR04/12 *Functioning and Oversight of Oil Price Reporting Agencies,* Report of the Technical Committee of IOSCO (March 2012) p. 8, http://iosco.org/library/pubdocs/pdf/IOSCOPD375.pdf

IOSCO's Focus

IOSCO's inquiry into the oil PRA price assessment process has revealed a variety of issues that concern IOSCO Members with respect to their oversight of commodity derivatives markets that trade oil derivatives contracts that reference PRA derived prices. Such issues include, among others, the adequacy of a commodity derivatives contract's design, the accuracy and integrity of price formation in a commodity derivatives contract that references a potentially deficient price assessment, the transparency of the various factors impacting oil derivatives pricing including PRA assessment processes, and the susceptibility of an oil derivatives contract to manipulation. See IOSCO's *Principles for the Regulation and Supervision of Commodity Derivatives Markets* for a detailed discussion of these issues.[7]

The contract design principles set out in that IOSCO report illustrate the critical impact that an inadequate or inaccurate price assessment could have on an oil derivatives contract. In general, a key objective of the contract design principles is to eliminate, to the extent possible, the susceptibility of a commodity derivatives contract to price manipulation or distortion.[8]

In this regard, a brief discussion of the following contract design principle adopted by IOSCO is instructive, as it illustrates how an erroneous PRA price could impact an oil derivatives contract:[9]

> **Principle: Promotion of Price Convergence through Settlement[10] Reliability -** *Settlement and delivery procedures should reflect the underlying physical market and promote reliable pricing relationships and price convergence and should be regularly evaluated to ensure that they meet this standard. Settlement and delivery terms should be specified and made available to market participants.*

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[7] FR07/11 *Principles for the Regulation and Supervision of Commodity Derivatives Markets, Report of the Technical Committee of IOSCO* (Sept 2011) http://iosco.org/library/pubdocs/pdf/IOSCOPD358.pdf

[8] *Id. at p. 14.*

[9] FR07/11 *Principles for the Regulation and Supervision of Commodity Derivatives Markets, Report of the Technical Committee of IOSCO* (Sept 2011) http://iosco.org/library/pubdocs/pdf/IOSCOPD358.pdf

[10] Settlement is the act of fulfilling the performance requirements of the commodity derivatives contract. Settlement may be effected either by physical delivery or cash payments.

IOSCO's discussion of that principle made clear that the overarching concern is that the contract not be susceptible to manipulation or price distortion. The susceptibility of a commodity derivatives contract to manipulation or price distortion might arise from the market's structure itself (which may be more or less transparent, efficient and liquid) or, in the context of a PRA-developed price referenced by an oil derivatives contract, from the methodology used by a PRA to construct the price upon which settlement is based.[11]

A commodity derivatives contract will not be readily susceptible to manipulation or distortion if the price used for settlement is reliable (*i.e.*, the settlement price should accurately reflect prices in the underlying physical commodity market). Contract design considerations addressing reliability should include an analysis of the reliability of the physical commodity reference price on which pricing of the contract is based, availability and timeliness of pricing information, commercial acceptability and availability to all stakeholders of the price series or index that is used to calculate the cash settlement price, liquidity of the physical market and the potential for price manipulation or distortion of the price used for cash settlement.[12]

Contract design considerations should also ensure that the size of the sample used to determine the price series or index is sufficiently broad to be representative of the underlying physical market. The price series (or index) should be based on a sufficiently large record or survey of transactions such that it cannot be readily manipulated to advantage a position in the cash-settled contract. Moreover, the price series should be based on sufficient physical market activity – geographically and seasonally – covering a broad cross-section of market participants.[13]

All of these considerations are raised by the PRA price assessment process.

Preliminary Areas of Potential Concern

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[11] FR07/11 *Principles for the Regulation and Supervision of Commodity Derivatives Markets, Report of the Technical Committee of IOSCO* (Sept 2011*)* http://iosco.org/library/pubdocs/pdf/IOSCOPD358.pdf The 2011 report's discussion of structural and methodology concerns has been set out in the current report as it is instructive for a Market Authority's (defined therein) inquiry into PRA developed price assessments.

[12] FR07/11 *Principles for the Regulation and Supervision of Commodity Derivatives Markets,* Report of the Technical Committee of IOSCO (Sept 2011) at p. 22. http://iosco.org/library/pubdocs/pdf/IOSCOPD358.pdf

[13] *Id.*

Viewed in this light, IOSCO's examination of the operations of PRAs has disclosed areas of potential concern which, if not addressed appropriately by a PRA, could create conditions that make an oil price assessment, and any commodity derivatives contract that uses that assessment as a reference price, susceptible to manipulation or distortion. In addition to the consultation, IOSCO members also are bringing to this project their own individual experiences in approving and/or reviewing derivatives contracts that reference PRA assessments.

It should be noted that these areas of potential concern are preliminary and do not necessarily reflect the full scope of the areas of concern that may be addressed in a final report. IOSCO continues to evaluate and discuss, in collaboration with the IOs, the issues that have been raised by its consultation, as well as the form of further engagement with the PRAs and stakeholders.

These areas of potential concern include:

Methodology

A key concern with respect to the methodology used to construct a price is that the data from which it is derived will not be susceptible to manipulation or otherwise artificially influenced or distorted.

Based on this concern, IOSCO contemplates that likely recommendations may focus on ensuring the quality and public availability of procedures for the assessment process, including for example, certain expectations concerning the existence and public availability of objective criteria used by a PRA in its assessments, how the methodology handles variations in underlying markets, how changes to assessment criteria are made, and mechanisms to ensure reasonable ability for users of markets impacted by those assessments to raise concerns with a PRA well in advance of a change in methodology (e.g. seeking the feedback and exchange of views with stakeholders before any change in methodologies or establishing any new methodologies).

Judgment

The Standing Committee acknowledges that certain discretion may be required to assess spot crude markets. The fact that assessments involve the exercise of judgment, however, contributes to the potential for manipulation or other abusive conduct to influence price assessments. Likely recommendations may focus on safeguards to prevent or minimize the possibility of such manipulation. Such safeguards might include having an objective and transparent set of criteria against which any judgment is exercised, including with respect to the exclusion of any information that has been received by a PRA, the publication of any such exclusions with an explanation of the grounds for exclusion and how the exercise of judgment should be memorialized and retained as a record for an appropriate amount of time.

Transactions used in price assessments

IOSCO understands that a PRA price assessment is based on bids, offers and trades that are reported voluntarily and that this creates opportunity for a trader to submit a partial picture, i.e. an incomplete set of its trades in order to influence the assessment to the trader's advantage (*e. g.*, to advantage a derivatives market position).

It is likely that the Standing Committee will consider the need for recommendations that address the "bona fide" nature of information considered in the assessment process (i.e., bids, offers, transacted volume and actual trades), for example through a process of internal controls that validate the veracity of information considered. Other possible areas for recommendations may include a consideration of whether all of the information considered in an assessment should be disclosed to the market, and whether procedures to identify "arms-length" (i.e., between independent parties) transactions are needed.

It is also likely that recommendations may be considered that address the completeness of information that is submitted to a PRA (e.g., if a trader reports transaction data, should it be required to report all of its transaction data or at a minimum all transactions that might influence the relevant price assessment), and whether there should be some mechanism to discipline adherence to such a requirement and whether there should be requirements on the status of the persons at a reporting entity who are eligible to report information to a PRA.

Trade reconstruction

Concerns have also been raised that all of the information considered and judgments made in forming a price assessment should be memorialized with sufficient information to identify the persons submitting and analysing the information.

Therefore, we contemplate the consideration of recommendations with respect to establishing audit trail requirements enabling reconstruction of how the PRA reached a particular assessment.

Independence and Avoidance of Conflicts of Interest

Based on IOSCO members' regulatory experience with financial services firms, as well as certain comments from the consultation, we contemplate that we will discuss the need for recommendations that focus on ensuring that the assessment process is made by independent analysts and is not tainted by conflict of interest. Such concerns typically are addressed through written policies setting out the establishment of "firewalls" within firms, an internal supervisory process and PRA staff disclosures.

Complaints

Many commenters focused on their inability to challenge an assessment or other practices at the PRA. Both the Task Force and the IOs noted that we should distinguish between a complaint over price (which must be determined quickly) and non-price sensitive complaints regarding operational or methodological issues. Markets need the certainty that prices published as 'final' will stand. Commenters discussed the need for a transparent complaint resolution process, recognizing the need in some circumstances that price sensitive decisions must be resolved in real time. Certain comments also called for the need for a dispute resolution process independent from the PRAs to be available in appropriate circumstances.

Document Retention

The ability to reconstruct an audit trail, access the price assessment process and investigate possible market manipulation requires the existence of actual records for examination. Any possible recommendations noted above would be rendered meaningless if there were no document retention requirement. Accordingly, recommendations for document retention and unhindered and prompt disclosure to market authorities will be discussed.

External Accountability Mechanisms

In the absence of statutory regulation of PRAs, there is no external enforcement entity or mechanism to ensure compliance with any recommendations for PRAs. Possible approaches to this problem include: an independent review committee at the PRA providing regular reports to stakeholders, some form of mandatory and appropriately transparent audit of the PRA's compliance with recommendations, and/or a follow-up review by IOSCO, in collaboration with the IOs, of the extent to which PRAs have adopted and implemented the final recommendations to be made by IOSCO. Market authorities might also consider whether to make compliance with IOSCO's recommendations a condition for a market to list a commodity derivatives contract referencing a PRA assessment.

Next Steps

The Standing Committee is in the process of finalizing a draft set of recommendations that will be circulated to members and the IOs for comment and further discussion with the intent to deliver a final report of recommendations as contemplated by the G20 Leaders. The Standing Committee will consider further stakeholder engagement as appropriate as recommendations are finalised.[14]

[14] *As well as its Consultation Report, which was made available for public comment, the Standing Committee notes that it met with representatives of leading PRAs to discuss the G20 mandate in January 2012.*