

COVER NOTE

Update to Survey on the Principles for the Regulation and Supervision of Commodity Derivatives Markets

November 2018

In response to the request by the G20 at its November 2010 summit in Seoul, Korea, IOSCO published the *Principles for the Regulation and Supervision of Commodity Derivatives Markets* (the Principles) in 2011. At their core, the Principles aim to ensure that the commodity derivatives markets serve their fundamental price discovery and hedging functions, while operating free from manipulation and abusive trading schemes.

IOSCO's third implementation review of the Principles is a response to the G20 Leaders' request in 2013 for monitoring of the implementation of the Principles on a regular basis. In its second review, published in 2014, IOSCO had highlighted that a number of initiatives still remained under development and/or in various stages of implementation, and a more definitive analysis of those initiatives would be provided through a further review that will be conducted when the majority of significant initiatives reach key milestones.

Since a number of major reform initiatives have now reached their implementation phase (e.g., MiFID 2 in the European Union), IOSCO carried out a third review of the Principles, the findings of which will be published before the G20 Leaders' summit in November 2018. This third review captures developments in the regulation and supervision of commodity derivatives markets since the second implementation review in 2014.

A survey of relevant IOSCO members was used to prepare the third review. Such an approach provided an opportunity for IOSCO members to self-audit their current regulatory practices, identifying the implementation of measures to satisfy the requirements of the Principles. EU member states prepared a single joint response.

Similar to the results of the second implementation review, the third review revealed that the majority of the respondent IOSCO members are broadly compliant with the Principles. Among other things, Annex A of the report shows that IOSCO members have made substantial progress towards achieving full compliance, and in many cases, have further strengthened those Principles. Annex B provides a corresponding summary of the updated survey results, showing the specific areas in which IOSCO members have achieved compliance through the implementation of regulatory reforms.

Overall, the 2018 survey findings indicate that IOSCO members have made improvements across all areas described in the Principles. IOSCO believes the third review concludes this exercise requested by the G20 and, unless there is a further review request by the G20, this report will constitute the final implementation review.

ANNEX - Summary of the Principles

The Principles address various aspects of exchange traded commodity derivatives products and their trading, such as design; surveillance; addressing disorderly markets; enforcement and information sharing; and enhancing price discovery:

Contract Design Principles

- **Principle 1: Accountability** – *Market Authorities should establish a clear framework as to design and review criteria or procedures for commodity derivatives contracts. Market Authorities should be accountable for compliance with statutory and/or self-regulatory standards on a continuing basis and should retain powers to address the provisions of existing contracts which produce manipulative or disorderly conditions. At a minimum a statutory Market Authority should have legal powers to address and where necessary to vary contract provisions which produce, or are deemed likely to produce, manipulative or disorderly conditions.*
- **Principle 2: Economic Utility** - *Contracts should meet the risk management needs of potential users and promote price discovery of the underlying commodity.*

The design and/or review of commodity derivatives contracts should include a determination that the contract can meet the risk management needs of potential users of the contract and/or promote price discovery of the underlying commodity. The determination of economic utility may be supported by surveys of potential contract users or may be implied - for example, from an analysis of the physical market.

The regulator should, as a minimum requirement, be informed of the type of products to be traded on an exchange or trading system and should review and/or approve the rules governing the trading of the product.

- **Principle 3: Correlation with Physical Market** - *Contract terms and conditions generally should, to the extent possible, reflect the operation of (i.e., the trading in) the underlying physical market and avoid impediments to delivery.*
- **Principle 4: Promotion of Price Convergence through Settlement 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.*
- **Principle 5: Responsiveness** - *The views of potential contract users should be taken into account in designing commodity contracts.*
- **Principle 6: Transparency** - *Information concerning a physical commodity derivatives contract's terms and conditions, as well as other relevant information concerning*

delivery and pricing, should be readily available to Market Authorities with respect to all derivatives transactions within its jurisdiction and to market participants in organized derivatives markets.

Without limiting the factors that a Market Authority includes in those terms and conditions, market rules should specify, for example:

- i) Minimum price fluctuations (price ticks);*
- ii) Maximum price fluctuations (daily price limits), if any;*
- iii) Last trading day;*
- iv) Settlement and delivery procedures;*
- v) Trading months;*
- vi) Position limits, if any;*
- vii) Reportable levels; and*
- viii) Trading hours.*

Principles for Surveillance of Commodity Derivatives Markets

- **Principle 7: Framework for Undertaking Market Surveillance** - *Market Authorities should have a clear and robust framework for conducting market surveillance, compliance and enforcement activities and there should be oversight of these activities. A market surveillance program should take account of a trader's related derivatives and physical market positions and transactions. Market surveillance programs should be supported by sufficient resources, access to physical market data and analytical capabilities.*
- **Principle 8: Monitoring, Collecting and Analyzing Information** – *Market Authorities should develop, employ and maintain methods for monitoring of trading activity on the markets they supervise, collecting needed information and analyzing the information they collect that are efficient and suitable for the type of market being supervised. Effective monitoring of orders and electronic transactions requires real-time monitoring capabilities, supported by automated systems that detect trading anomalies. Monitoring, collection and analysis should also focus on intra-day trading.*
- **Principle 9: Authority to Access information** - *Market Authorities should have the authority to access information on a routine and non-routine basis for regulated commodity derivatives markets as well as the power to obtain information on a market participant's positions in related over-the-counter (OTC) commodity derivatives and the underlying physical commodity markets. In particular, Market Authorities should have the power to:*
 - i) access information that allows the reconstruction of all transactions on a regulated commodity derivatives market (audit trail);*

- ii) *access information that permits them to identify large positions (i.e., “large exposures” or “concentrations”) and the composition of the market in question;*
- iii) *access information, if needed, on the size and beneficial ownership of positions held by a market participant in order to aggregate positions held under common ownership and control;*
- iv) *access information about a market participant’s transactions and positions in related OTC and physical commodity markets; and*
- v) *take appropriate action where a commodity derivatives market participant does not make requested market information available to the Market Authority.*

Market Authorities should review the scope of their authority to obtain such information and if necessary to request such power from the relevant legislature or other appropriate governmental bodies.

- **Principle 10: Collection of Information on On-Exchange Transactions** – *In respect to on-exchange commodity derivatives transactions, a Market Authority should collect information on a routine and regular basis on:*

- i) *pricing of contracts throughout the trading day in real time;*
- ii) *daily transactional information including time and date of trade, commodity contract, delivery month, expiry date, buy/sell, quantity, counterparties to the contract, and price of the contract;*
- iii) *daily reports of end-of-day positions held by market intermediaries (both “whole firm” and by individual trader) and by other market participants, where the size of the position is above a specified level (“large position”). Information collected should permit a Market Authority to identify each position holder (by name or code) down to the first customer level, and the size of position, by contract month, for each position holder.*

The Market Authority should have the capability to aggregate position holder information promptly in order to identify positions under common ownership or control;

- iv) *where appropriate, warehouse stocks or other deliverable supply.*

- **Principle 11: Collection of OTC Information** – *In respect of OTC commodity derivatives transactions and positions, a Market Authority should consider what information it should collect on a routine basis and what it should collect on an “as needed” basis. A Market Authority that has access to a relevant Trade Repository’s (TR) data should take such broader access into account, as well as its statutory obligations with respect to the TR, in constructing its data collection policies.*

Information could include, as appropriate:

For information collected on a routine basis:

- i) *transactional information including time and date of transaction, contract terms and, counterparties to the contract and price of contract; and*
- ii) *position information.*

For information collected on an as needed basis

- i) *delivery intentions;*
- ii) *beneficial owners;*
- iii) *positions under common control; and*
- iv) *for contracts other than forwards, additional information may also need to be sought on notional values, replacement cost, valuation methodology or duration of the contracts.*

- **Principle 12: Large Positions** – *Market Authorities should require the reporting of large trader positions for the relevant on-exchange commodity derivatives contracts. The Market Authority should have the ability to aggregate positions owned by, or beneficially controlled on behalf of, a common owner.*

Principles to Address Disorderly Commodity Derivatives Markets

- **Principle 13: Intervention Powers in the Market** - *Market Authorities should have, and use, effective powers to intervene in commodity derivatives markets to prevent or address disorderly markets and to ensure the efficiency of the markets. These powers should include the following:*

1) Position Management Powers, Including the Power to Set Position Limits - *Market Authorities should have and use formal position management powers, including the power to set ex-ante position limits, particularly in the delivery month.*

These should necessarily include position management powers that:

- (a) *Establish a trader's automatic consent to follow an order of the Market Authority when that trader's position reaches a defined threshold size or any size, which the Market Authority considers prejudicial to orderly market functioning, taking into account all relevant circumstances. They should also require such a trader to comply with the Market Authority's order, either not to increase a position or to decrease a position; and*
- (b) *Authorize a Market Authority to place ex-ante restrictions on the size of a position a market participant can take in a commodity derivatives contract (i.e., position limits).*

2) Other Discretionary Powers - *Market Authorities should also have the powers*

to employ any of the following measures, as appropriate to address market disruption or the perceived threat of such disruption or to assist market surveillance efforts:

- a) the imposition of price movement limits;*
- b) calling for additional margin, either from customers or from clearing members on behalf of their clients;*
- c) ordering the liquidation or transfer of open positions;*
- d) suspending or curtailing trading on the market (e.g., trading halts and circuit breakers);*
- e) altering the delivery terms or conditions;*
- f) cancelling trades;*
- g) requiring owners of positions to specify delivery intentions; and*
- h) requiring traders to disclose related OTC derivatives or large physical market positions.*

- **Principle 14: Review of Evolving Practices** - *Market Authorities should have, or contribute to, a process to review the perimeter of regulation to ensure that they have the power to address evolving trading practices that might result in a disorderly market. Exchanges and self-regulatory organizations play a critical and complementary role with governmental regulators in identifying such practices.*

Principles for Enforcement and Information Sharing

- **Principle 15: Rules and Compliance Programs** - *Market Authorities should have rules, compliance programs, sanctioning policies and powers to prohibit, detect, prevent and deter abusive practices on their markets, including manipulation or attempted manipulation of the market. The rules and compliance programs should take account of the whole position of the market participant (i.e., all positions under common ownership and control). There should be clarity as to what constitutes manipulative, abusive conduct or other prohibited conduct.*

Specific practices which Market Authorities should seek to detect and prevent include, among others:

- i) causing, or attempting to cause, artificial pricing in the market;*
- ii) creating a false or misleading appearance of active trading;*
- iii) disseminating false or misleading information in respect of the market or conditions that affect the price of any commodity;*
- iv) creating, or attempting to create, a corner or squeeze, in which an abusive*

controlling position is accumulated in the physical and/or futures or OTC markets, forcing those holding short positions to settle their obligations, by purchase or offset or otherwise, to their detriment;

- v) *abuse relating to customer orders;*
 - vi) *"wash trades", involving no change of beneficial ownership or economic purpose;*
 - vii) *collusive trades, which seek improperly to avoid exposure to the pricing mechanism of the market;*
 - viii) *violation of applicable position limits;*
 - ix) *concealment of a position holder's identity and,*
 - x) *misuse of information.*
- **Principle 16: Framework for Addressing Multi-Market Abusive Trading** - *The overall framework for market surveillance and enforcement within a jurisdiction should be structured to provide for active and coordinated detection and enforcement action against manipulative or abusive schemes that might affect trading on multiple exchange and OTC markets, as well as the underlying physical commodity markets.*
 - **Principle 17: Powers and Capacity to Respond to Market Abuse** - *Market Authorities should have adequate powers and capacity to investigate and prosecute actual or suspected market abuse, including attempted manipulation. IOSCO members that are responsible for the oversight of commodity derivatives markets should have all of the powers required by the IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (MMOU).*
 - **Principle 18: Disciplinary Sanctions Against Market Members** - *The relevant Market Authority should have and use effective powers to discipline its members or other authorized market participants if an abusive practice has occurred in the market. There should be clarity as to the types of disciplinary actions which can be taken.*

Sanctions should, amongst other things, include some or all of the following measures:

- i) *warnings (public and private);*
- ii) *reprimands;*
- iii) *re-training;*
- iv) *restitution;*
- v) *disgorgement of illicit gains*
- vi) *fines;*

- vii) *conditions on trading;*
- viii) *trading prohibitions;*
- ix) *suspension from membership;*
- x) *expulsion from membership; and*
- xi) *where appropriate, a criminal referral.*

- **Principle 19: Disciplinary Sanctions Against Non-Members of the Market**

The relevant Market Authority should have power to take action against non-members of regulated commodity derivatives markets or other market participants if they have engaged in abusive or manipulative practices, or are suspected of doing so. Market authorities may require contractual relationships between members and customers that enable action to be taken. It is anticipated that enforcement powers will usually be embedded in statute and would be exercised by a government body, including a public prosecutor or the courts.

In addition, Market Authorities should be able to intervene, or cause the exchange to intervene, in the market to address or to prevent an abuse by non-members, using appropriate measures - through members - such as for example by raising the level of margin, imposing trading limits and liquidating positions, as well as removing trading privileges. Any intervention action should be timely.

- **Principle 20: Information Sharing - Market Authorities should cooperate with one another, both domestically and outside the jurisdiction, to share information for surveillance and disciplinary purposes. In particular Market Authorities should have arrangements that allow them to share information on large exposures in linked markets and on supplies relative to these markets. These arrangements should take account of (as applicable):**

- i) *The Exchange International Information Sharing Memorandum of Understanding and Agreement (Exchange International MOU) and the Declaration on Cooperation and Supervision of International Futures Exchanges and Clearing Organizations (Declaration), which facilitate the identification of large exposures by firms that could have a potentially adverse effect on multiple markets;*
- ii) *The IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (MMOU); and*
- iii) *Guidance issued by IOSCO in respect of information sharing, such as IOSCO's Principles Regarding Cross-Border Supervisory Cooperation, Report on Multi-jurisdictional Information Sharing for Market Oversight, and Guidance on Information Sharing.*

Information sharing to facilitate heightened surveillance is warranted where

physical commodity derivatives contracts trade on different exchanges and are linked economically, such as where one contract's settlement price is determined by reference to the settlement price of the other contract.

Principles for Enhancing Price Discovery on Commodity Derivatives Markets

- **Principle 21: Commodity Derivatives Market Transparency.** *Market Authorities should publish the aggregate exposures of different classes of large traders, especially commercial and non-commercial participants, within the bounds of maintaining trader confidence.*

- **Principle 22: OTC Transparency** – *IOSCO Members should promote the reporting of OTC derivatives contracts to trade repositories in order to improve transparency, mitigate systemic risk, and protect against market abuse in commodity derivatives markets. The relevant governmental regulator of commodity derivatives markets should work with regulators responsible for trade repositories to:*
 - i) *evaluate what improvements are appropriate to enhance the usefulness of, and access by regulators to and disclosure to the public of, OTC commodity derivatives market data that is reported to trade repositories; and*

 - ii) *take affirmative steps such as encouraging ongoing work by the industry, rulemaking or recommending legislative changes to achieve these objectives.*