Regulation of Commodity Derivatives Markets

Assessment and Shortcomings: Europe and UK

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Food and Commodities:
Financialisation, price volatility and the need for reforms
Expert Meeting
Friedrich Ebert Foundation, Brussels
29th November 2010

US and European regulation

US futures market regulation has always been more advanced than in Europe

And it is ahead now: Dodd-Frank

Why?

US futures markets

…are part of domestic trade
- used by US farmers, airlines, food companies etc etc

including agricultural commodities traded in Chicago
- started at the railhead serving the Mid-West farms

European futures markets

…are mostly in London

- arose from UK's *international* trade:
- Tropical crops
- Imported metals (e.g. copper, tin)
- Grains *imported* to London and Liverpool
    - close link with shipping

European futures markets

"Domestic" European futures are a recent development

- Not as deeply rooted in commercial practice as in US

UK futures markets

UK futures markets are part of the City of London

- together with financial markets
- all are seen as separate from rest of the UK economy, and somewhat mysterious
- less scope for public pressure than e.g. over Dodd-Frank legislation in the US

Growth of European derivatives and commodity markets since late 1970s

New markets:

- ❑ Financial futures from 1982
- ❑ Other financial derivatives from mid-1970s
- ❑ London Metal Exchange adds Al, Ni contracts
- ❑ LME moves from forward to futures trading
- ❑ Oil futures
- ❑ New agricultural futures markets, e.g. Paris wheat, rapeseed, maize (corn)
- ❑ But some markets moved to producer regions, e.g. tea auctions, natural rubber futures

Growth of European derivatives and commodity markets since late 1970s

New instruments – options added to futures trading

New institutional structure:

- ❑ Exchanges demutualised
- ❑ Most (but not the LME) were amalgamated or taken over by international groups
- ❑ Commodity broking was integrated with:
  1. Other areas of commodity business
  2. Investing banking and hedge funds
     - ❖ Now dominated by the latter

Besides futures regulation?

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- Michael Atkin
Agricultural Commodity Markets: A guide to futures trading (Routledge, 1989), p. 56

Besides futures regulation?

Other known means of dealing with commodity price volatility:

- ❑ **Agriculture policy**
  - ❖ Price supports, marketing boards, public stocks etc
- ❑ **Supply management, including international agreements**
  - ❖ Have existed e.g. for tea, wheat, tin, coffee over long periods

UK commodities regulation

Tradition of self-regulation

- ❑ The "light touch" has continued under the Financial Services Authority since 2000
- ❑ Works with the exchanges as self-governing entities
- ❖ Statutory objectives of FSA:
  - ❑ Market confidence
  - ❑ Public awareness
  - ❑ Consumer protection
  - ❑ Reduction of financial crime

Gaps and inadequacies

- UK regulation only applies to institutions in the UK
- Does not distinguish commodities from finance
- Commodities get overlooked: insufficient staff and specialist knowledge
- **NO** public reporting requirements
- **NO** public restraints on trading (e.g. position limits)
- **NO** official distinction between "commercial" and "non-commercial" (speculative) activities
- All problems to be addressed by an exchange's own authorities
- The UK has not even dealt with serious cases of market abuse effectively, e.g. the Sumitomo case

EU regulatory instruments

The EU's Single Market has led to certain EU-wide regulations (all of them presently under review):

Market in Financial Instruments Directive	MiFID	2004 - 2007
Market Abuse Directive	MAD	since 2003
Undertakings for Collective Investment in Transferable Securities	UCITS III	2001 - 2004
Capital Requirements Directive	CRD	2006 - 2009

Planned additional EU directives

AIFM Alternative Investment Fund Managers Directive (mainly hedge funds)

Derivatives and Market Infrastructures (on central clearing)

Also: Christine Lagarde's call for a European equivalent of the CFTC

Gaps and inadequacies

- ***Market*** regulation is still left to Member States
- even though most of the markets concerned are international in scope

The regulations at EU level:

- still do not distinguish between commodities and finance
- do not regulate the futures markets themselves; nor are there plans to do so
- have no reporting requirements, position limits etc