

# Commodity Markets Update

## February 2014

**Foreword by David Lawton, Director of Markets**



Commodities matter. The price of commodities is directly visible in many of the things we consume as well as a whole range of the manufactured goods we buy. It affects the costs of business and so commodity prices are a key driver of inflation as they are of economic activity.

Commodity derivative markets are a vital underpinning to the wider commodity markets, providing open and standardised market places for the coming together of the full range of buying and selling interests, allowing transparent and orderly price determination and the management of price risk within a regulated framework. In the UK it is the FCA that has responsibility for regulating commodity derivatives and it is these markets that are of primary interest to us.

This is a time of fundamental change in the commodity derivatives markets. The growth of markets, and related financial products, over the longer term, has driven a significant increase in political and regulatory interest.

Here we set out the Financial Conduct Authority's (FCA's) views on the regulatory challenges arising from commodity derivative markets and how the FCA is aiming to address them through its approach to market policy and supervision.

We will keep you up to date with the latest developments in policy and supervision and, as part of our ongoing dialogue, I look forward to hearing your views on the shape of the industry.

David Lawton

## The FCA's priorities

In this update we seek to explain how commodity derivative markets – which matter to us all – are changing. In response to these changes, the regulatory regime – both in the UK and internationally – needs to be adapted to ensure robust and appropriate oversight of commodity derivatives markets.

Consequently, we are and will be responding in the following ways:

We will deliver high quality and effective oversight of the commodity derivative markets we regulate. To achieve this we will continue our intensive supervision of trading platforms and regulated entities active in UK commodity derivative markets, addressing the risks we have identified in this paper. By extension, this will also require continued engagement with a wide range of market participants active in the commodity derivative markets; not just UK-based regulated entities, but also unregulated foreign-based firms, including trading companies.

We remain committed to taking a leading role in international commodity derivative policy work, including in ESMA and IOSCO.

We will ensure a rigorous application of our market abuse regime, which in time will include effective implementation of the new EU market abuse legislation.

We will continue to develop our bilateral dialogue with physical regulators, such as Ofgem, given the close inter-dependencies between physical and commodity derivative markets.

We will review how to keep our stakeholders updated on our progress in these priorities, and we welcome your views on the shape of the industry and our role within it.

## Market background

The FCA regulates commodity derivatives, but not the underlying physical markets.<sup>1</sup> We supervise firms and market operators and we also work closely through our counterparts overseas and with physical market authorities such as Ofgem. The FCA plays a leading role in developing commodities policy and regulation globally through IOSCO and within Europe through ESMA.

Our supervision and policy work reflects the FCA's overall strategic objective of ensuring that markets work well, as well as the operational objectives of consumer protection, protecting market integrity and promoting competition. Within these, the protection and enhancement of the integrity of the UK financial system has been the primary focus.

In this context, our approach is based upon intensive supervision of commodity derivatives markets and of the key regulated participants within them, supplementing this ongoing work with periodic 'deep dives' looking at particular emerging risks and trends. Since the crisis new measures have been introduced or agreed, predominantly at the EU level, with the intention of bringing these markets more comprehensively within the scope of mainstream regulation. The FCA will be playing an active role in the implementation of these new measures.

Commodity markets by their inherent nature pose a specific set of material challenges because they straddle the regulatory perimeter. The interaction of financial commodity markets with the physical market gives rise to a range of specific conduct, reputational and environmental risks. The FCA's remit for consumer protection is in formal terms for the consumers of investment products, but it is through our interaction with other agencies, such as physical market regulators, that we are part of the wider framework of physical commodity market oversight. So, alongside the significant volume of business being undertaken in regulated commodity derivatives markets, there is activity that is not directly subject to financial services regulation but which nevertheless has an interaction with our objectives and is therefore of interest to us. This manifests in the following ways:

Market integrity is affected by price formation taking place in the underlying physical market, and by physical delivery and storage mechanisms.

Physical market participants not regulated by the FCA affect prevailing standards of market conduct.

Abusive behaviour can occur in the physical commodity markets which in turn can have an impact on, or be directly linked with, financial market activity and prices.

In addition, commodity markets are crucial to the real economy and are therefore subject to considerable and increased political and public scrutiny. These factors combine to present challenges for regulators, firms and market operators which we develop further in this update, focusing on the emerging risks and challenges for market participants and supervisors.

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<sup>1</sup> We use the term 'commodity markets' to mean both the financial commodity derivative markets that we regulate and underlying physical market which we do not. We use 'commodity derivative' and 'physical' when we specifically mean these.

## Market Supervision: Promoting the FCA's objectives

There are seven main strands to our work in promoting the FCA's objectives within the commodity markets.

The intensive, risk-based supervision of market infrastructure providers, comprising Recognised Investment Exchanges and Multilateral Trading Facilities, which focuses on both the governance arrangements and infrastructure of the organisations as well as the quality of the markets they operate.

The supervision of market participants. The detail of the regulatory obligations will vary by type of participant. They may, as appropriate, include prudential requirements to ensure safety and soundness<sup>2</sup> as well as conduct of business requirements and client asset rules to ensure consumer protection. All participants in regulated markets are subject to market conduct and market venue rules.

Preparation for integrating the position and transaction information that we will receive under MIFID and EMIR. This reporting will transform the visibility to us of these markets and enable us to further develop an active surveillance role.

Our active enforcement of abusive behaviour in these markets. The FSA took formal enforcement action on a number of occasions in relation to commodity market behaviour.<sup>3</sup> Last year, the FCA concluded its first enforcement action in commodities.<sup>4</sup>

Ongoing work to enhance our knowledge of the physical commodities markets and how they interact with the related financial markets. The relationship between the physical and financial markets will receive more focus from European regulators as the new Market Abuse Regulation takes effect. The work that the FCA is conducting will allow us more effectively to deter abusive behaviour in these markets.

Cooperation with other agencies is key, because of both the global nature of the markets as well as interaction with the underlying physical markets. We maintain a number of bilateral contacts, most notably with the CFTC and Ofgem. Because of its responsibility for the enforcement of REMIT in the UK and, given the interaction between the physical and financial markets, we are continuing to develop our regular dialogue and formal arrangements for cooperation with Ofgem.

The development and implementation of policy. The later section on regulatory developments illustrates the breadth of the current policy agenda underway.

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<sup>2</sup> The supervision of prudential requirements for banks is undertaken by the Prudential Regulation Authority.

<sup>3</sup> 2009 - finding against David Redmond, an oil and freight trader:  
<http://www.fsa.gov.uk/library/communication/pr/2009/065.shtml>

2010 - finding of market abuse against Stephen Perkins, an oil broker:  
<http://www.fsa.gov.uk/library/communication/pr/2010/109.shtml>

2010 – finding of market abuse against Andrew Kerr, a broker in the coffee market:  
[http://www.fsa.gov.uk/pubs/final/andrew\\_kerr.pdf](http://www.fsa.gov.uk/pubs/final/andrew_kerr.pdf)

<sup>4</sup> 2013 – finding of market abuse against Michael Coscia, an oil trader:  
<http://www.fca.org.uk/news/fca-fines-us-based-oil-trader>

## Key trends and market data

This is a time of fundamental change in the commodity derivatives markets. There has been significant growth of commodity markets, particularly related commodity derivative products over the last decade. This, taken together with the importance of commodities to the global economy, has led to a significant increase in political and regulatory interest.

We see the key current trends in commodity derivative markets as follows:

- (1) Over a longer term outlook, say the last five or ten years, activity from virtually every type of participant active in commodity derivative markets has grown materially, as evidenced by volumes traded and also investor assets under management. This longer term context should be kept in mind when considering more recent reverses in growth.
- (2) There has been a changing balance in commodity derivative market participation. Over the past two to three years, banks have in general reduced the scale of their commodities activities, whilst commodity trading companies have assumed a greater role. These changes impact on the specific business models of firms we supervise as well as challenges in maintaining market oversight and the potential for the emergence of conduct risk.
- (3) Commodity derivative markets remain relatively small, both in size and in terms of associated quantitative risk in comparison to other asset classes, as set out in the box below. So, as in 2007<sup>9</sup>, while we note the importance of commodity derivative markets, they should be seen in proportion when considering the highest priority risks to our objectives. Nevertheless, because of the impact upon the real economy, commodity markets have an importance upon our work beyond a narrow interpretation of our statutory objectives. We continue to believe that commodity markets pose a set of specific regulatory challenges that need to be explicitly reflected in our approach to policy formulation and supervision.

### Box 1. Market data

Commodity derivatives represent \$3 trillion of outstanding over the counter (OTC) derivatives globally, less than 0.5% of the total across all asset classes.<sup>5</sup>

Exchange commodity futures and options open interest is around \$1 trillion globally, 14% of all futures and options.<sup>6</sup>

UK exchanges' open interest represented 68% of global industrial metals exchange-traded open interest and 32% of global energy exchange-traded open interest.<sup>7</sup>

UK exchanges' commodity market activity is currently underpinned by approximately £12 billion in initial margin.<sup>8</sup>

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<sup>5</sup> Bank for International Settlements

<sup>6</sup> Futures Industry Association

<sup>7</sup> JPMorgan Research

<sup>8</sup> FCA

<sup>9</sup> In 2007, the FSA published a paper, *Growth in Commodity Markets*, following a thematic review of market activity.

[http://www.fsa.gov.uk/pubs/other/commodity\\_invest.pdf](http://www.fsa.gov.uk/pubs/other/commodity_invest.pdf)

(4) In response to the financial crisis, financial market regulators are now constructing and implementing a series of regulatory changes of unprecedented scope and complexity, both specific to commodities and more generic measures. These changes are intended to reduce systemic risk and increase market transparency and integrity. The changes, having been initiated as a response to the developments in the market, are now themselves a major driver of market evolution. As we set out in our section on Regulatory Change, these changes are far reaching and transformational. We fully support the outcomes that these measures are designed to achieve and will continue to engage with market participants to ensure effective implementation of new regulations and monitor the effects upon market structure and integrity.

The FCA has been at the forefront of regulatory developments in commodity derivative markets both globally – through IOSCO – and in Europe. This update indicates our thoughts and our priorities. It focuses on the practical challenges that result from the trends we are seeing in commodity markets, noting that the issues we have identified are not now those of growth, but of an industry under some pressure.

For more detail on the macroeconomic background there is extensive material in the public domain, including the drivers of commodity prices, the impact upon prices of speculation, and the rise of ‘financialisation’ – the increasing interaction of the commodities and wider financial markets. We note particularly the recent publication of a study by the Centre for European Policy Studies<sup>10</sup>, to which the FSA contributed at an early stage.

## Changes in market participation

A distinguishing feature of the commodity markets is the broad range of types of participants, from universal banks to specialist commodity firms. There have always been ebbs and flows in the prominence of differing segments of market participants and, currently, the trend is towards a decline in the activity of the banks and a rise in the role played by commodity trading companies.

Firms undertaking investment activities in the UK are required to either obtain FCA authorisation or hold a legitimate exemption. As a general rule, authorised firms include the full range of financial market participants – banks, specialist investment firms, brokers, asset managers. However, this may not include firms that undertake trading purely on their own account and which operate as customers of market intermediaries, or those firms which restrict their activities to physical markets rather than financial.

For **banks**, until around 2009 the commodity markets were attractive as a potential source of revenue supposedly negatively correlated with other asset classes. Since then, sentiment-driven and largely directionless markets, alongside declining client interest, has seen total revenues for the leading ten commodities investment bank businesses across the globe fall to just below a third of their peak, from \$14.1bn in 2008 to \$4.5bn in 2013, with no foreseeable prospect of recovery<sup>11</sup>. At the same time, there has been a rise in regulatory costs and risks associated with undertaking this business, as one of the asset classes most affected by regulatory change. This has translated into business model challenges and we have seen firms both completely exit the field and substantially reduce the scope of their activities,

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<sup>10</sup> <http://www.ceps.eu/book/price-formation-commodities-markets-financialisation-and-beyond>

<sup>11</sup> Figures provided by Coalition, *Coalition Index – FY 2013*

particularly moving away from physical activities. This is partly illustrated by the reduction in headcount in the sector; headcount in commodities roles within the leading ten investment bank businesses across the globe has fallen by over 20% in just a few years, from 2,794 employees in 2010 to 2,176 in 2013<sup>12</sup>.

As well as the fall in revenues, the lower Value at Risk measures (VaRs) of the leading commodities banks is evidence of a trend of a fall in risk taking, though it is not possible to untangle the impact of declining volatility from that of general deleveraging or risk reduction.

Commodities businesses continue to account for a relatively small part of the overall investment bank trading activity, so we acknowledge that the quantitative risks to the firms provided by changes to their commodities business model is relatively small compared to other asset classes. Therefore market conduct risks are more likely to be the focus of our supervisory engagement with the banks in this area.

**Commodity trading companies**, always active, are becoming increasingly significant participants in commodities markets, in part facilitated by the scaling back of activity by the banks, although there are differing perceptions on the extent to which their activities overlap. Overall, there has been a general theme of non-bank entities taking a more prominent role at the expense of banks. This trend may continue into the future, partly assisted by the evolving regulatory landscape, with non-bank entities able to leverage less stringent capital requirements and operate without enforced remuneration restrictions.

Commodity trading companies have historically been privately owned and therefore only make limited information publicly available. But this is not exclusively the case as some have sought public listings or raised public debt offerings, which has given greater insight into the operation and performance of certain of these trading companies.

Outline summary data on these firms is increasingly available from a number of secondary sources. For example, the analysis by the Swiss Federal Council<sup>13</sup> published in March 2013 is that Switzerland has 35% of global crude oil trading and 60% of global metals trading, a market share that reflects the trading companies domiciled there rather than the size of the underlying Swiss economy.

Trading companies will not be entirely unaffected due to the cross-border impact of, for example, Dodd Frank and EMIR, as well as the regulatory changes affecting the commodity derivatives markets in which the trading firms operate. But the regulatory reform measures will not fall evenly on types of market participants, which is likely to accelerate the current trends in changes to market structure.

The trading companies do not all share the same characteristics of business models but they generally adopt asset-light business models with a focus on the 'mid-stream' (storage and transportation) in moving commodities from locations where there is surplus supply to locations of supply deficits. However, in many cases they are now extending into upstream and downstream sectors. These firms are playing an increasingly critical role in the functioning of an ever more complex global economy, though this underlines the importance of applying the right regulatory approach rather than itself being a concern for financial regulators.

Trading companies have tended to locate the bulk of their activities in less transparent jurisdictions. While a number of the trading companies have operations of varying sizes in the UK, none of the groups is

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<sup>12</sup> Figures provided by Coalition

<sup>13</sup> <http://www.news.admin.ch/message/index.html?lang=en&msg-id=48319>

primarily based here. We do in some cases authorise UK legal entities, which tend to constitute a minor part of the wider commodities business and which do not provide us with insight into the activities of the whole group.

Operating in plain sight, the trading firms represent a 'known unknown' that quite naturally attracts attention from regulators and central banks and will continue to do so. Most of their activity is carried on from outside the UK, so any change in their regulatory status would be a matter for international consideration rather than a question for the FCA.

In the meantime, while these firms are largely not subject to financial services regulation, they are significant participants in regulated markets. So while they are subject to the FCA's market conduct rules for UK regulated activity, as well as the rules of the UK exchanges where they trade on these venues, the rise in proportion of activity on London markets by unregulated, overseas entities poses a challenge to our market supervision, alongside risks to market standards and integrity.

It has been argued by some regulators and market participants that they may also pose systemic risks; a point difficult to assess while there is still relatively limited published financial information on these firms, either to the market or to regulators. One way we are responding is to develop a dialogue with the trading firms over which we do have a direct regulatory remit, particularly in relation to market conduct and financial crime risks, and we welcome their constructive response to this initiative.

**Oil majors and the gas and power utilities** are an essential part of the infrastructure and as such are subject to governmental oversight in a number of ways. The FCA's interest is in the significant role they play in commodity derivative markets.

The structure of the energy markets means that these firms tend to be direct market participants; in other asset classes the analogous end users are more likely to access the market through regulated intermediaries. Given their consequent impact on market integrity, we therefore need to maintain an active dialogue with them. In general, these groups do have FCA authorised entities, but they are not subject to comprehensive prudential or reporting regulatory requirements and the groups tend to be structured so that capital requirements are not applied to the trading positions. We therefore have less information on their financial position than in the case of conventional financial firms and groups. We are accordingly considering options for work in this area to inform our policy formulation ahead of the CRD IV review of prudential requirements for commodities firms.

## **Conduct risks for firm supervision**

The changes in market participation mean that we have had to adjust our supervisory approach to the relevant firms.

Commodity market activity creates a specific set of material risks for firms peculiar to this market, largely due to the interaction between financial market activity and the physical product, unregulated counterparties and developing jurisdictions. Issues such as market abuse, management of information flows, conflicts of interest and miss-selling risks to corporate clients and to investors can therefore arise in ways different to other asset classes. Market participants also face environmental risks where they are involved in the transport and storage of physical commodities.



We have observed that financial crime risk can arise in relation to compliance with sanctions regimes, lack of understanding and awareness of bribery and corruption risks to and from the business, firms' assessment of relationships with high risk customers, most notably with politically exposed persons (PEPs). In general, we have observed different standards across the industry on 'know your customer' (KYC) requirements. Firms regulated by the FCA must remember their regulatory requirements when it comes to identifying, assessing and mitigating financial crime risks.

The intense public and political scrutiny of the commodity markets means that firms active in these markets are subject to heightened reputational risk. Firms can suffer damage to their franchise, and ultimately business model, through adverse press coverage and regulatory or political attention, not due to misfeasance, but simply because of their involvement in one or more aspects of commodity market activity.

Both environmental and reputational risks may not be thought of as regulatory issues, but we have a clear interest because of the potential damage to market confidence and integrity as well as to the business model and franchise of individual firms.

Because of the range of types of commodity market participants, personnel can move into a senior trading position in an authorised firm without previously having worked in a regulated environment. This poses a control risk unique to the sector.

These points are in addition to those risks applicable to a wider range of firms. For example, in the context of the FCA's focus on duties to clients and unbundling, there is an increased focus on the adherence of trading with MIFID-based conduct of business requirements (e.g. best execution, use of dealing commissions). This has the potential to encompass commodities areas as well.

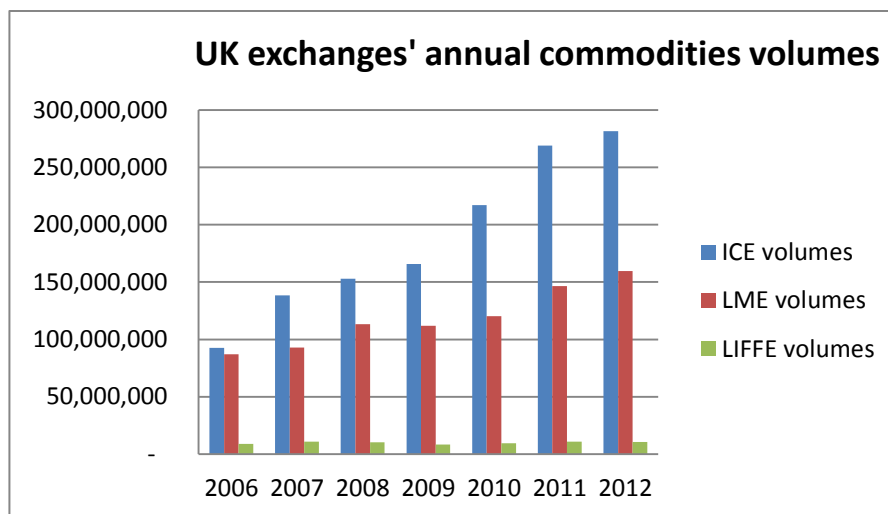
We expect regulated firms to identify and mitigate conduct risk across their business generally, and would equally expect them to be able to recognise and manage the particular aspects relating to commodities.

For firms engaged in commodity market activity, as in other business lines, our focus will be on the implication of firms' business models. We will continue to be particularly vigilant against two risks. First, we will seek to ensure that senior management of firms entering the sector fully understand the relevant risks, and we will verify that robust control frameworks are put in place. Second, we have noted evidence that business risk appetites are weighted towards commercial considerations and we will be alert to any trend for market standards to become subject to 'a race to the bottom' as a result of regulatory and competitive inequalities. We will continue to raise these issues with firms as a part of our normal supervisory engagement.

## **Price formation and market integrity**

Over the long term, say the last 20 years, we have seen a trend of strong and continued growth in commodity derivative market activity as a result of both the commodities super-cycle – notably driven by growth in China and the Far East – and the impact of market liberalisation, which has allowed for the development of traded markets that had not previously existed. However, set against this longer term context, we have more recently seen a decline in liquidity in some areas.

Exchange volumes are a subset, albeit an important one, of the wider commodity derivatives market and in the UK the experience has been one of continued growth.



Source: LME, ICE Futures Europe & NYSE Euronext

Because commodity markets straddle the boundary between regulated financial activity and physical commodity activity that is outside financial services regulation, they present particular risks to the price formation process. Two aspects of this are particularly notable.

First, the role of warehouses where these are part of the delivery and settlement process for exchange contracts. The operation of warehouses licensed by Recognised Investment Exchanges (RIEs) is not a regulated activity. However, the FCA has a formal interest in warehousing because of the role it plays in ensuring that RIE derivatives contracts which incorporate warehouse arrangements are adequately anchored to the price of the underlying product and because of the central function warehouses play in ensuring orderly settlements more generally. Recent public comment has raised a number of concerns in this area. The LME has recently announced policy changes following a consultation on the particular issues in its market whilst LIFFE has recently introduced warehouse load out rates for cocoa. We have been fully engaged with the LME's consultation process and will seek to ensure that the impact on market integrity/orderliness has been fully addressed. The interest in these issues is generating momentum internationally, and so a coordinated regulatory response may be desirable.

Second, the role of physical commodity benchmarks. Some commodity derivative exchange contracts and many financial products cash settle in reference to physical commodity benchmarks. While we do not regulate the physical market, or directly related benchmarks, the FCA has played a leading role in international efforts to raise standards in key areas, notably through the development of IOSCO's guidelines for Oil Price Reporting Agencies<sup>14</sup> which we fully support. These Principles aim to improve the functioning and oversight of oil price reporting agencies within a voluntary framework by encouraging behaviours of best practice to improve internal controls, increase transparency, ensure the integrity of information and therefore promote the reliability of price assessments. IOSCO is continuing its work to assess the effective implementation of the Principles.

<sup>14</sup> Published in October 2012: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD391.pdf>

The EU Commission in September 2013 published its own proposals for benchmark regulation.<sup>15</sup> This proposal is wide-ranging, applying to benchmarks used in financial markets, but encompassing also those benchmarks relating to commodity markets. It sets out that national regulators, such as the FCA, will be a continuing part of the regulatory framework; we are engaging fully in the development and implementation of these proposals.

Assessing the impact of physical market activity upon market integrity remains a key priority for us in these markets and work in both the areas highlighted above will remain a prominent feature of our activity with respect to commodity markets.

## Investor activity

Investor activity in the commodity markets has been one aspect of 'financialisation', the increasing interaction between commodity markets and the wider financial markets. This gives rise to risks to the FCA's consumer protection objective: commodity markets are historically volatile and we would be concerned if there was evidence of a lack of understanding by investors of the risks associated with commodities or signs of a growth in levels of exposure to what is generally accepted as only appropriate as a relatively minor part of a balanced portfolio.

Commodities as an asset class has traditionally been viewed as an inflation hedge with the benefits of non-correlated diversification. Diversification is less effective if prices are driven by the demand side, which has been the case in recent years since the 2008/9 collapse across all asset classes, as it means that prices tend to depend, as with other asset classes, on general economic performance. Through 2013, this pattern of correlation changed. For example, equity markets in some developed economies significantly outperformed the commodities sector as a whole. It remains to be seen whether this pattern will persist or we will see a reversion to the picture of the last few years.

Commodity assets under management globally reached a steady \$400-450 billion<sup>16</sup> through 2011 to 2012, roughly three times the level from when the FSA carried out its thematic review in 2007. At that time, the FSA expected that investor interest would grow. While this has been true for the intervening seven years as a whole, the trend has more recently turned from stagnation to decline, with the November 2013 total reaching \$332 billion.

Within product types, however, the pattern is more complex than the headline figures immediately convey, as further elaborated on below.

**Exchange traded products** (ETPs) have taken on a significant portion of the overall total since the first gold Exchange Traded Fund (ETF) was launched in 2005. This was a landmark moment as previously investors had been restricted to using derivatives markets to access commodities, hence limiting participation especially for a class of investor, such as certain US funds, for whom derivatives were – and remain – off limits.

Total commodities ETP volumes, at the end of November 2013, were \$124 billion, and of this, precious metals ETPs, overwhelmingly backed by gold, account for \$97 billion. This is down from \$172 billion at the

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<sup>15</sup> [http://ec.europa.eu/internal\\_market/securities/docs/benchmarks/130918\\_proposal\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/benchmarks/130918_proposal_en.pdf)

<sup>16</sup> Barclays Capital Research for the statistics on investor activity. All figures in this section reflect global activity.

start of the year as gold has moved out of favour with investors. This alone accounts for the entire fall in commodities assets under management. Precious metals ETPs should be seen as very different in motivation to other commodities investments: gold is regarded as a defensive investment and a store of value, in addition to a hedge against inflation that other commodities also offer.

The rise in commodities assets under management up to 2012 was driven by inflows into ETPs, just as ETP outflows are behind the decline in 2013. Taking these apart as qualitatively different in investment objective, there has been minimal growth in commodity investments over the period.

**Commodities index funds** have been a high profile type of investment, as the focus on the alleged impact of speculation on commodity futures prices. In line with the FCA's statutory objectives, our review focused on market developments and regulatory issues, rather than commodity prices *per se*. Funds under management and returns have declined: in November 2013, they stood at \$124 billion, down from \$159 billion at the end of 2010. S&P GSCI total returns in 2013 were minus 1.2% while the Dow Jones UBSCI total returns were minus 9.6; these compare to a 29.6% total return increase in the S&P500 over 2013. On a total returns basis, the historical performance of both the leading commodities indices has seen the S&P GSCI down 35% and the DJ AIG down 31% over the six years between 2008 and 2013 (this period includes the sharp fall in commodity prices in 2008).

**Commodity-linked medium term notes.** Cumulative outstanding notes grew from \$47 billion at the end of 2008 to \$85 billion in November 2013. However, the recent level of new issuance has been steadily reducing, driven by the difficulty of manufacturing products in a low interest rate environment, investors' desire to de-risk and in some cases, move away from complex products completely.

Our detailed analysis indicates that there is currently no identifiable trend to growth in the absolute level of investor interest in commodities, nor within that towards more complex products. Nor is there any discernible growth in direct exposures to commodities by retail investors in the UK, excluding exposure to equities where the FTSE index has a strong extractive industry component. While the risks we have identified of investor understanding of products and exposure to volatile markets remain valid concerns, in the absence of evidence of growth in activity, we will at this stage continue to monitor closely the level of investor activity and react quickly should we perceive increasing risk to our statutory objectives.

## Regulatory change

Commodity derivatives have been within the scope of UK regulation since the Financial Services Act 1986. A separate guide explaining how the regulatory framework applies to commodities is available on our website.<sup>17</sup> The regulatory approach and the powers of the FCA and our predecessor bodies continue to evolve and have done since that date.

As explained previously, given increasing political and regulatory focus on commodity markets, a number of measures have been introduced to bring them more comprehensively within the scope of mainstream regulation.

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<sup>17</sup> <http://www.fca.org.uk/your-fca/documents/guide-to-commodity-markets-regulation>

IOSCO published in 2011 its Principles for the Regulation and Supervision of Commodity Derivatives Markets, giving guidance on expected regulatory standards for IOSCO members. This was in response to the G20 stated commitment to enhance transparency and avoid market abuse in financial commodity markets. There are 21 separate Principles covering contract design, market surveillance, addressing orderly markets, enforcement and information sharing and enhancing price discovery. In 2012, IOSCO commissioned a survey of Member States to review implementation. In common with other EU states, the UK largely complies with the Principles and any shortcomings will be addressed by the EU legislation currently under negotiation and/or implementation.<sup>18</sup>

In recent years, the international driver for heightened standards for commodities markets has been the G20. Starting with the 2009 Pittsburgh summit, communiqués have driven a number of initiatives aiming to “improve the regulation, functioning, and transparency of financial and commodity markets to address excessive commodity price volatility”.<sup>19</sup> The FCA is fully engaged with implementing this agenda. Governments are now implementing G20 commitments, which are reflected in a number of EU legislative measures – notably MiFID<sup>20</sup>, EMIR<sup>21</sup>, REMIT<sup>22</sup> and MAD/MAR<sup>23</sup> – and the Dodd-Frank Act in the US.

The key changes that are being or are likely to be introduced will affect:

**Regulatory scope** – these measures bring a more consistent treatment of similar activity across different types of firms and support market integrity:

- more commodity firms, venues and products will be brought within regulatory scope and subject to the full range of regulatory requirements
- greater regulatory oversight will be provided by transaction reporting for commodity derivatives, and
- the provision of commodity benchmarks referenced in financial contracts will become a regulated activity.

**Systemic risk** – these measures address the potential for disruption arising from what is now a mainstream financial asset class:

- systemic bilateral risk will be reduced through mandatory clearing obligations for specified derivatives and risk mitigation requirements for un-cleared OTC trades, and
- the clearing obligation will apply to large non-financial firms, subject to a hedging exemption and thresholds that reflect the interaction between financial markets and the real economy

**Market transparency** – these measures are intended to improve market integrity and assist consumer protection:

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<sup>18</sup> <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD393.pdf>

<sup>19</sup> A summary of the developing international work can be found in the IOSCO report at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD358.pdf>

<sup>20</sup> The Markets in Financial Instruments Directive

<sup>21</sup> The European Markets Infrastructure Regulation

<sup>22</sup> The Regulation on Energy Market Integrity and Transparency

<sup>23</sup> The Market Abuse Directive and the Market Abuse Regulation

- standardised and liquid commodity derivatives will be required to trade on organised trading platforms and be subject to improved price transparency
- there will be greater transparency to regulators through reporting to trade repositories, and
- there will be a requirement for publishing Commitments of Trader reports (i.e. the regular publication of aggregated position information by category of trader)

**Market conduct** – these measures support market integrity, and address the inter-linkages and dependencies between physical and financial markets:

- there will be a comprehensive regime for position limits, supported by a position reporting regime, across all types of market venues
- the range of the market abuse regime will be materially advanced to include behaviour on MTFs and OTFs as well as Regulated Markets and extended to manipulative behaviour in physical commodity markets
- a market abuse regime has been introduced applying specifically to the physical gas and electricity markets, and
- there will be new offences to capture attempted market manipulation including benchmarks

In addition to these changes arising from EU legislation, IOSCO is also taking forward work on benchmarks while changes in capital requirements are being implemented under Basel III.

We believe these measures are necessary and appropriate to meet the regulatory challenges posed by activity in the commodity markets. This is with two provisos. First, these measures are still mostly in development or implementation stages and there is much work to do to ensure that they are applied proportionately and in a manner that achieves the desired outcomes without harming the proper role and functioning of the markets. Second, much of this new legislation gives effect to G20 decisions taken as far back at 2009. The markets have changed since then and the risks now are less about growing markets and a rising tide of speculative activity and more about a lack of liquidity and a retreat by classes of participants.

These measures are clearly already a very significant driver of market structure as firms seek to position themselves for implementation. Market participants have raised concerns about unintended consequences of these changes including a potential loss of market liquidity, reduction in customer choice, the moving of activity outside regulation or jurisdiction, a rise in competitive inequalities, and any rising barriers to entry. We will continue to assess these risks, and also the impact of cross-border regulation given that regulatory developments outside Europe also have a significant impact (notably the Dodd-Frank Act and Volcker rule in the US). This work will be undertaken on an on-going basis as part of the leading role we take in the work of both ESMA and IOSCO.

There is also a high degree of interrelatedness between some of these regulatory initiatives. One specific example is the treatment of physically settled commodity forwards traded on MTFs. These trades are classified as ‘financial instruments’ for the purposes of MiFID, and ‘OTC derivatives’ or ‘OTC derivative contracts’ for the purposes of EMIR.<sup>24</sup> However, it became apparent through discussions with market

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<sup>24</sup> The Regulation on OTC derivatives, central counterparties and trade repositories (648/2012/EU)

participants that there was no common view on the correct characterisation of trading taking place on the existing forms of broker-operated systems offering a market in these products. This matters because physically settled forwards conducted on an MTF will be within the scope of EMIR. Following discussions with us, the brokers reviewed and updated the functionalities offered by their systems to ensure clear distinctions between the MTF and non-MTF services they provide. We issued a statement regarding this work in November 2013.<sup>25</sup>

## Market engagement

We recognise that engaging with the regulatory agenda – both policy formulation and implementation – poses a significant overhead to firms and we have seen many firms build up their compliance and regulatory affairs resources as a consequence. However, we have also seen that awareness of these measures varies considerably across the market, especially amongst end-users who will be affected by many of them.

We encourage firms to ensure they understand and comply with the relevant requirements. These are complex in nature and often involve interrelated pieces of legislation and policy, which can be cross-border. The impact on firms will vary by their scope of activity. Firms must therefore ensure they have the relevant expertise to not only understand these changes but also effectively establish processes, procedures and – perhaps most importantly – build cultures that facilitate compliance.

We support work being undertaken by the relevant trade associations to enhance market understanding of and drive compliance with regulatory requirements. At the same time, we continue to prioritise our own external-facing activities to build awareness, through such measures as a recent programme of engagement with Non-Financial Counterparties on the implementation of EMIR.<sup>26</sup>

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<sup>25</sup> <http://www.fca.org.uk/news/firms/statement-about-broker-operated-systems-trading-physically-settled-gas-and-power-forwards>

<sup>26</sup> <http://www.fca.org.uk/firms/markets/international-markets/emir/implementation-reviews>