CESR CALL FOR EVIDENCE ON LEVEL II IMPLEMENTING MEASURES ON THE DIRECTIVE ON INSIDER DEALING AND MARKET MANIPULATION.

Joint-response prepared by Euronext.liffe, the International Petroleum Exchange of London (IPE) and the London Metal Exchange (LME).

Executive Summary

1. **The purpose of this paper is to:**
   - **(a) provide background analysis of the information disclosure requirements and accepted market practices in regulated commodity derivatives markets ('RCDM');**
   - **(b) offer recommendations to CESR in drafting Level II implementing advice on the definition of 'inside information' for derivatives on commodities.**

Key characteristics of regulated commodity derivatives markets ('RCDM')

2. The application of the Directive on Insider Dealing and Market Manipulation (the 'Directive') to derivatives on commodities must reflect the distinctive characteristics of the commodity markets. These key characteristics are:

   (a) **Nature of market users**. RCDM and their participants are wholesale in nature. There is little direct retail participation and most trading is for commercial or proprietary purposes. Non-retail investors use the derivatives to hedge price risk, to source physical commodities or for arbitrage. Users of RCDM include the full range of businesses with an exposure to the price of the underlying commodity. Using energy as an example, this may include producers, refiners, shippers, distributors and marketers, as well as large end users such as power generators, airlines, truck fleet operators, chemical companies and supermarkets. Liquidity is provided to the market by 'market makers' or 'Locals.' Typically, participants must be able to make or take (or arrange for another company to make or take) physical delivery of the underlying commodity unless cash-settled. Transactions on RCDM are generally of a large size and a significant proportion is carried out in order to offset underlying physical exposures or positions. Expert (professional) investors and traders also invest or speculate in commodity derivatives, perhaps to diversify portfolio risk.

   (b) **Role of RCDM**. Commodity derivatives fulfil two key roles:

      (i) ***Risk-spreading***. Derivatives on commodities allow producers and consumers to buy/sell futures contracts that fix the price of future purchases or sales and thereby reduce the risk of price volatility and uncertainty prior to delivery; and

      (ii) ***Price formation***. Market participants bring to the marketplace their knowledge of current supply and demand conditions and their future expectations. Prices change frequently as the participants revise or re-evaluate their views on the basis of new information, and buy and sell futures contracts in accordance with those expectations. The on-exchange price will often act as benchmark for underlying physical trading – for example, the IPE Brent crude futures contract acts as a benchmark price for two thirds of the world's internationally traded crude oil. LME Official Prices are used to fix the price of physical transactions in base metals traded as derivatives on the Exchange even though parties to the physical deals might not use the LME for hedging or acquisition of the metals. The same is true of the commodity contracts traded at Euronext.liffe, particularly in respect of Cocoa, Robusta Coffee and White Sugar.

(c) **Regulatory remit**. If the underlying market for the purchase/sale of commodities is regulated, it is by a different authority to that which supervises RCDM. Neither the over-the-counter market nor the underlying physical market are subject to regulation by the operators of RCDM, which are responsible for the detection of market abuse on their markets. [1]

(d) **Competition.** In most sectors, the main competitors for Europe's commodity derivatives exchanges are currently situated outside the EEA rather than within the Union – e.g. Euronext.liffe, the IPE and the LME compete with the New York Board of Trade (NYBoT), New York Mercantile Exchange (NYMEX), NYMEX (Comex) and the Shanghai Futures exchange respectively. Electricity is an exception as there are a number of RCDM, such as NordPool, EEX and Powernext, offering on-exchange trading in electricity derivatives where, while it may appear, *prima facie*, that there is a competitive market, due to the difficulty of transporting and storing electricity, they are to all intents and purposes national markets.

Information disclosure in the commodity markets

3. Information disclosure in the commodities derivatives markets serves two main purposes: (i) it allows market users to take investment decisions; and (ii) it assists market authorities in ensuring that their markets remain proper and orderly. Disclosures fall into three main categories:

(a) **Disclosure by the market operator**. The market operator will publish this information in paper form, on the internet or via quote vendors and will include:

- ***Order and trade information***. Market authorities publish order and trade information – such as bid/offer prices, volumes of orders and price/volume of trades on a daily basis.

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[1] For example, while the FSA supervise trading of OTC electricity futures, options and swaps which is *investment business* under the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, the Office of Gas and Electricity Markets (OFGEM) regulates generators and suppliers of electricity. Meanwhile, the operators of RCDM are responsible for market surveillance, supervision, and regulation of on-exchange trading, subject to overriding statute or regulations set by their competent authorities. Also, the UK Listing Authority ('UKLA') sets disclosure requirements for listed companies. Market operators of RCDM are responsible for market surveillance, supervision, and regulation of on-exchange trading, subject to overriding statute or regulations set by their competent authorities.

This information is made available to market users (perhaps with a time lag) depending on the market rules;

- ***Open interest and volume information***. Traded volume, and open interest as at the day's end, is published on a contract-by-contract basis;
- ***Stock information***. Where contracts are satisfied by physical delivery of the underlying commodities – perhaps in the form of warrants issued by warehousekeepers listed (approved) by the regulated market - warehousekeepers provide periodic returns, in some cases daily, to the regulated market of all warranted stock in their warehouse(s). Typically, the market operator will publish the aggregate of this information and insider dealing ahead of unpublished warehouse data could be a form of market abuse;
- ***Position information***. Market authorities might require their members to provide information to them on client positions. While this data might simply assist the market authorities in oversight of the markets, the market authorities might publish the information in a summarised and/or anonymous form to give market users additional information that might assist them in reaching investment decisions;[2]
- ***Reference price information***. Where contracts are cash-settled - i.e. there is no delivery of the underlying commodity but simply a cash payment based on a closing reference price set for a contract and the difference between the initially traded price and the reference price - market authorities calculate and publish the reference price based on an agreed and published formula. As outlined in the Tokyo Communiqué on Supervision of Commodity Futures Markets, futures contracts should, to the extent possible, be designed to ensure correlation with the underlying cash market at expiry;[3]
- ***Periodic disclosure***. Contract specifications are kept under constant review and may be changed accordingly. Changes can have a considerable impact on contract price. It is likely that such amendments will be discussed with the Exchange's Board or Consultative Committee prior to implementation. Trading ahead of the public announcement of such information could be to the advantage of a trader and/or his firm to the disadvantage of other market users. This applies equally to 'insiders' who are or become aware of market interventions planned by market or competent authorities, for example to limit positions

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[2] For instance, the London Metal Exchange requires its members to provide it with information daily on positions held by their named clients – the information required varies according to market rules, so in some contracts, the LME requiring details for all positions whereas in others it is only large positions. This information is then published on an anonymous basis on the internet. Compliance with the LME's large position rules is a 'safe harbour' under the FSA's Code of Market Conduct.

[3] The Tokyo Communiqué on Supervision of Commodity Markets, Annex A: Guidance on Standards of Best Practice for the Design and/or Review of Commodity Contracts, page 17. A copy of the Communiqué can be found at http://www.cftc.gov/files/oia/oiatokyorpt.pdf

or impose backwardation limits, and trade ahead of announcement of the intervention. Such trading would be a breach of confidentiality;

- **Key market data**. Users of commodities markets use a vast amount of information that is published on a regular basis by a diverse range of organisations. This information could be supplied at a national or international level. Examples of this type of information include:

  - For soft & agricultural commodities, the International Cocoa Organisation, International Coffee Organisation, International Sugar Organisation, Home Grown Cereals Authority, Grain and Feed Trade Association, Organisation Nationale Interprofessionelle des Oléagineux, Nederlandse Aardappel Organisatie and other such bodies regularly publish statistics or other relevant information relating to those products traded as derivatives at Euronext.liffe;

  - For oil trading, announcements from Government changing the tax regime - such as the 10% supplementary charge on North Sea profits announced in the 2002 Budget;; information about the US Strategic Petroleum Reserve (SPR) published on a daily basis by the US Department of Energy; and trading in the underlying physical commodity. Such information is published by, for example, Petroleum Argus and Platts; and
  - For base metals, the International Nickel Study Group, the International Copper Study Group, the International Wrought Copper Council, the World Bureau of Metal Statistics, the Organisation of European Refiners and Remelters, and other such bodies regularly publish statistics on production and consumption of those base metals traded as derivatives on the LME.

(b) **Specific disclosures**. Individual companies might have an obligation to disclose information relating to, for example, refinery shut-downs (say, information about an oil refiners capacity), low crop yields or mining volumes where it is significant to their share price, valuation, or profitability under the rules of the regulated market where that company's shares are admitted to listing. However, where this is not the case, there is no obligation to release such information – for example, there is no obligation to report a major supply interruption to operators of RCDM. In any case, the market impact of the information is dependent on the relative importance of that particular producer or user to the total production or usage of the commodity.

4. In relation to information disclosure in the commodities markets, it is also important to note that:
   - with the exception of information issued by the competent authority of the market in question, much of the **information is germane and generic**. In contrast to the equities markets where

information will – in general terms - be specific to one individual company, it might not, therefore, be relevant to the price of commodity derivatives;

- market participants **do not rely** on the disclosure of announceable information but on their analysis of total supply and demand on a continuing basis;
- there is **no contractual relationship** with the underlying information provider and operators of RCDM. It should be noted that the information providers might be listed outside the EEA;

Mechanisms of information disclosure

5. For RCDM, there is no formal mechanism for the disclosure of information – such as for the Primary/Secondary Information Provider regime in the UK's equities markets. Much of the information published by operators of RCDM is published on the Exchange's website – for example, in the case of Euronext.liffe, cocoa and coffee grading information, for the IPE, the Brent Index; and for the LME, large position information - or via quote/ information vendors. A number of price reporting agencies also run news agencies – such as Platts and Argus – and information is available for an annual fee. Magazines such as Futures and Options Weekly also serve to provide generic information to the market.

Accepted market practices

6. The freedom of market participants to exercise complete commercial discretion to act on the information to hedge risk and manage changes in supply and demand is vital to the process of securing supply, stabilising commodity prices (which flows through to consumers) and predicting cash flows.

7. Europe's commodity derivatives markets have evolved to meet the specific needs of users of the physical commodities.[4] Given the history and subsequent developments of these markets, there is a huge diversity of membership, contract structure, settlement and delivery. **There is therefore no clear definition of accepted practices which can be applied equally to all markets**. It is therefore essential that accepted market practices are determined on a market-by-market basis.

8. As discussed above, with the exception of transaction information, the market does not generally expect to receive specific information from market participants about the underlying physical market. In certain situations, information might even be withheld with the consent of a government agency or similar body.[5]

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[4] In the case of cocoa a derivatives market has existed since the 1920's, while the LME celebrated its 125th anniversary in 2002.

[5] By way of example, when a contract is entered into for the supply of oil to the US SPR, the US Department of Energy will delay the public announcement of the winning bidder for several days in order to allow the winning bidder to prepare to implement (or hedge) the contract prior to the market learning of the general requirements of the contract. The Department of Energy "withholds this contract, delivery and bid information in part to prevent actions by crude oil market participants that could increase a contractor's transportation costs or "squeeze" the contractor by bidding up the price of oil suitable for the SPR." "The US Strategic Petroleum Reserve: Recent policy has increased costs to

Recommendations for CESR's mandate

9. In light of the previous discussions, it is recommended that CESR's advice to the Commission on possible Level II implementing measures for the proposed Directive:

   - should be drafted at a **high-level** in order to enable national regulators at Level III to develop an appropriate regulatory regime which reflects accepted market practices in each of the markets which they supervise;
   - should **define** inside information **narrowly** in order to catch only that information linked to the commodity derivative contract itself rather than the underlying physical commodity, i.e. to the deliverable supply of the commodity that sellers can deliver to meet their settlement obligations;[6]
   - should not set standards of disclosure found in the equities markets that are **inappropriate** for commodity derivative markets;
   - should not impose obligations on operators of RCDM that extend beyond their **regulatory remit** – i.e. that extend to the physical commodity markets.

10. We would welcome the opportunity to discuss these recommendations and any of the points raised in this submission further.

Nick Weinreb
Group Head of Regulation
Euronext

Marc Leppard
Director - Regulation
International Petroleum Exchange

Alan Whiting
Executive Director of Regulation and Compliance
London Metal Exchange

consumers but not overall US energy security" Report by the Permanent Subcommittee on Investigations (March 5, 2003) Footnote 26, page 26

[6] For example, for the LME North American Special Aluminium Alloy contract this would be aluminium alloy conforming to LME NA380.1 specification that is held on LME warrant and stored at an LME listed warehouse in an approved delivery location.