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Regulating Speculation in Food Commodities

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1. The regulation of commodity markets in the U.K. and the EU

Regulation of the United Kingdom's commodity markets is designated partly by the European Union (EU) and partly by the U.K. government. It is carried out by the Financial Services Authority (FSA), under its Wholesale Markets division (Managing Director: Sally Dewar). The FSA was set up by the Financial Services and Markets Act (2000), supplemented and in some ways superseded by more recent EU regulations under the Single Market programme. The 2000 Act gave the FSA four statutory objectives:

1. Market confidence: maintaining confidence in the financial system;
2. Public awareness: promoting public understanding of the financial system;
3. Consumer protection: securing the appropriate degree of protection for consumers; and
4. The reduction of financial crime: reducing the extent to which it is possible for a business to be used for a purpose connected with financial crime.[1]

None of these four points covers the behaviour of the financial markets as such; indeed, the first two seem more like a PR campaign on their behalf. Nor is commodity market regulation split off from financial regulation, as it has been for many years in the U.S. There, the Commodity Futures Trading Commission (CFTC) was founded in 1974, combining two previous U.S. bodies, the Grain Futures Commission (founded in 1922) and the Commodity Exchange Authority (of 1947). As a recent FSA paper stated, 'The FSA does not have dedicated rules for commodities and commodity derivatives markets. Rather, its regulation of commodities markets is derived from several different regimes and its overall approach combines these.'[2] In another paper written jointly with the Treasury, the FSA confirmed that the interpretation of commodity market regulation is very narrow:

> In commodity markets the regulatory debate has been focused on two discrete issues:
> i Combating market manipulation
> ii Controlling or limiting price movements
> The first issue is a regulatory objective of the UK Authorities, whereas the second issue is not as it falls outside the current remit of the FSA (as defined by legislation).[3]

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[1] Copied from the FSA's website, www.fsa.gov.uk/pages/About/Aims/Statutory/index.shtml. (Note: all websites cited in this paper were visited in January 2010 unless stated otherwise.)

[2] Doyle, E., *et al* (2007), 'Growth in Commodity Investment: Risks and challenges for commodity market participants', London: FSA, www.fsa.gov.uk/pubs/other/commodity_invest.pdf, p.8.

[3] FSA and H.M. Treasury (2009), 'Reforming OTC Derivative Markets: A UK perspective', www.fsa.gov.uk/pubs/other/reform_otc_derivatives.pdf, p. 31.

Despite the momentous events on the commodity markets since 2007, the FSA's current business plan only contains one short reference to commodities:

> Over the coming year we will continue to review, including within the CESR and IOSCO, whether there is sufficient **transparency in non-equity markets trading**. The credit crisis (among other things) has prompted regulators to revisit arrangements for fixed income, credit derivatives, structured products and commodities, where a significant amount of trading takes place OTC. We are committed to ensuring that any changes to the transparency regime are justified by market failure analysis and have costs proportionate to benefits.[4]

This suggests that only OTC trade ('over-the-counter', i.e. outside organised exchanges) should be scrutinised, and then only concerning its transparency and only if the authorities are persuaded that a market or markets have actually 'failed'. This is the U.K.'s traditional light-touch, informal regulation, with the unspoken assumption that even the most powerful and unstable markets are generally best left to their own devices. It matches the political attempts to play down the financial crisis (and London's role in it) as a 'global crisis' or one 'imported from U.S. sub-prime lending', despite the central role that London's banks and markets played, and the ideological underpinning of the international system which was laid by successive British governments, starting in 1979.

The FSA justifies its position like this:

> Members of UK exchanges are required to abide by the position reporting requirements as set out in the rules of the exchange. These rules also give the exchanges authority to manage [trading] positions at any time throughout a contract's life cycle and to instruct a member to close or reduce a position with the exchange, if that is necessary, to secure fair and orderly markets. If the member does not comply, the exchange has the power to close the position unilaterally…
>
> We do not … consider that there should necessarily be a distinction made between 'large speculative' and 'large non-speculative' positions for the purposes of combating manipulation – the focus should be on combating 'large positions that lead to manipulation' irrespective of whether they are held by financial participants or not.[5]

So no distinction is made (as it is in the U.S.) between 'commercial' and 'non-commercial' (i.e. speculative or financially based) activity, while regulation is delegated to the authorities of a market themselves. It is all thoroughly untransparent, since the information on market positions is not published, nor are any discussions between either an exchange's authorities and a trader or between the FSA and the exchange, unless they should happen to leak into the press. Moreover, the FSA is primarily interested in financial markets, commodity markets work rather differently from them, and the FSA is very

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[4] FSA (2009), 'FSA Business Plan 2009/10', www.fsa.gov.uk/pubs/plan/pb2009_10.pdf, pp. 21-22 (emphasis in the original). CESR is the Committee of European Securities Regulators, IOSCO is the International Organisation of Securities Commissions.

[5] FSA and H.M. Treasury (2009), *op. cit.*, pp. 33 and 34, paras 9.14 and 9.19.

short of staff that really understand commodities. According to a Reuters commentator, there is 'an enormous source of confusion about what is and is not permitted', partly because the FSA has

> …a dearth of expertise on commodity matters. Commodities are a very small part of the regulator's remit. The institution has failed to build up the specialist personnel, knowledge and market contacts it needs to be able to take its own independent view and cross-check the information it is receiving from the exchanges and their members.

This is because the commodity markets were historically 'assumed to be dominated by knowledgeable "professionals" who could be expected to look after themselves, rather than "retail" investors. So a light touch regime which prevented obvious abuses (such as fraud) was all that was required.'[6]

That has been a problem with regulation of the City ever since its gentlemanly 'My word is my bond' days came to an end in the 1970s. It is all far too complacent when faced with the pressure and complexity of modern global trading and finance. It has led to shocking regulatory failures – in banking, for example, the collapse in 1984 of Johnson Matthey Bankers, a member of the London Gold Fix and therefore accepted as part of a reliable inner core of banks that did not require detailed regulation under the legislation of the day. On the metal markets there was the Sumitomo case, which was represented as the work of a single rogue trader when it came to light in 1996. According to a detailed recent account, that trader, Yasuo Hamanaka, was the chief copper trader in London of Sumitomo (a major copper company) and the representative of the Japanese Smelter Pool. The writer said Hamanaka and his associates had already 'gamed the public, the regulatory agencies and even his own management' for ten years:

> Sumitomo engineered a 1 million ton option strategy to control the LME [London Metal Exchange] copper stocks, which were about 500,000 tons at the time. The face value of the underlying long [position] was about $2 billion. This … might have been the largest futures or raw material position ever.

The manipulation only came to light when it washed over into the New York Commodity Exchange (COMEX) and the CFTC took action:

> It demanded extensive information on LME customer activity from U.S. brokers. Those that held back information were subject to fines and censure. None of this made the LME very happy.

The author, an experienced metals trader, described the LME's attitude thus:

> The LME based its reactions on the marketplace. When the backwardation [the difference between spot and forward prices] exceeded a certain level, it intervened. COMEX looks to position size, particularly as a delivery approaches maturity. Another difference was that U.S. regulators insist on knowing the beneficial owner of a position; the U.K. did not…

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[6] Kemp, J., 'Spotlight falls on London commodity regulation', Reuters Blogs, July 9th, 2009, http://blogs.reuters.com/commentaries/2009/07/09/spotlight-falls-on-london-commodity-regulation/.

> The LME chose a policy of benign neglect. After all, Sumitomo was the industry leader, and it's comfortable to believe that big strong companies are also virtuous.[7]

A similar allegation was aired by a former compliance director at the International Petroleum Exchange (IPE, later taken over by the U.S.' ICE), who referred to:

> …the sort of nonsense I blew the whistle on 8/9 years ago on the IPE, where there was systemic abuse of the 'Settlement Trade' mechanism, much of it on rollovers. It was so pervasive that the IPE locals called it 'Grab a Grand'.
>
> Unfortunately for me, the powers that be didn't want the Brent market brought into disrepute, so they buried the allegations, buried me, slapped a couple of wrists, quietly changed the rules and that was all right then![8]

Those 'powers that be' were faithfully carrying out the FSA's mandate of 'maintaining confidence in the system'. About more recent volatility in the oil market, the same former official blames:

> …the so-called Wall Street refiners, that really got moving in the early 1990s: Goldman Sachs, JP Morgan, Citigroup. Their participation is purely financial, and they're in the market to make a profit. They have a financial interest in volatility, as that's where they make their money…
>
> …this month there's only something like 53 cargoes coming out of the North Sea for the BFOE [Brent, Forties, Oseberg, Ekofisk]. That's worse than it's been in years. So it only takes about $2 billion to buy them all and control them. So for someone like a BP or a Goldman, it doesn't take too many forward contracts to actually support the price…
>
> My theory is that, over quite a few years, the bubble inflated through a lot of hype, by the likes of Goldman and others.

This official's proposal for dealing with the problem is this:

> A good starting point would be to simply set up a global registry of transactions, so that every transaction, both on and off an exchange, should be registered with a database or a custodian somewhere. Then it would be available for regulators to look at, if they want to. It's a practical starting point, and a simple one too.[9]

How does the U.K. fit in with EU regulations? The U.K. was brought under the EU's umbrella by the widening of the internal market to include financial services. There are no exemptions from its rules, but as Europe's biggest financial centre the City's bargaining position is strong in the definition of those rules. There are two regulations of note: the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive and the Markets in

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[7] Riess, M. (2003), 'Modern Market Manipulation', presented at the International Precious Metals Institute 27th Annual Conference, San Juan, Puerto Rico, www.materialsmanagement.net/modern_mkt_manipulation.htm.

[8] Comment by ChrisJCook (2009) at http://ftalphaville.ft.com/blog/2009/02/24/52836/the-united-states-oil-fund-mystery/.

[9] Crigger, L. (2009), 'Chris Cook: Energy ETFs not to blame', www.hardassetsinvestor.com/features-and-interviews/1/1703-chris-cook-energy-etfs-not-to-blame.html.

Financial Instruments Directive (MiFID). Both of them were created to regulate financial investment, including that in derivatives, rather than the commodity markets as such.

UCITS provides a set of rules that investment funds have to abide by if they want to sell throughout the EU rather than in just one member state. It goes back originally to 1985 but its latest version, UCITS III, was introduced in 2005. It revised the rules to permit funds to invest up to 10 per cent of their value directly in derivatives, rather than using them only for hedging. Allied with strict rules on diversification and risk management, this means that traditional funds can now pursue more active trading strategies – more like hedge funds. After the financial crash in 2008, when about 2,000 hedge funds were destroyed worldwide, some of them have also decided to enter this territory by setting up UCITS funds themselves. This requires that they should be onshore (based within the EU, not a tax haven), which is a novelty for hedge funds. UCITS also imposes other restrictions, for example on indebtedness ('leverage'), investment in physical commodities and liquidity. A fourth version, UCITS IV, is under preparation at present.[10]

MiFID came into force under EU internal market regulations in November 2007, and brought commodity traders under the same regulatory net as those in financial derivatives. They also have to comply with another EU regulation, the Capital Requirements Directive (CRD), which established minimum levels of capital required by firms in order to conduct financial business. MiFID extended the range of commodity derivatives permitted to investment funds, and recognised a new category of 'systematic internalisers', permitted to deal on their own account in executing clients' orders. MiFID was estimated to affect nearly 100 specialised commodity firms in the U.K. It permits exemptions to its rules for firms that primarily use the commodity markets for trade (hedging) rather than speculative or investment purposes.

Clearly, it will require a major change of attitude, not just at the FSA itself but in the legislation, if we were to add to its present narrow objectives any ambition to prevent wider social or international interests from being damaged by activities on British markets. The EU's approach offers better prospects of positive change via its leverage over the British government. The wider economic situation after the crash is still sufficiently fluid to permit that, provided that British public opinion can be mobilised to support a proper regulation of the commodities trade.

[10] *Financial Times*, FTfm supplement, January 11th, 2010.

2. EU initiatives to regulate derivatives and financial markets

Since 2008 the European Commission has launched investigations into the food price crisis and financial regulation, including derivatives and alternative investment funds, and these are to be followed by proposals for new EU directives in these fields. This is discussed further in section 5. There have also been discussions of new rules for financial regulation, including the fields of derivatives and investment, which touch on commodities. The most important was the report of a group led by Jacques de La Rosière, a former head of the International Monetary Fund, but it had almost nothing to say about commodities trading or derivatives. It did recommend that regulation, in the U.S. as well as the EU, should extend to cover the 'parallel banking system' (sometimes called the 'shadow' banking system), meaning hedge funds, investment banks and various off-balance sheet items. On derivatives, the report wrote of the 'need to take a wide look' at their functioning, including their possible simplification, standardisation, risk mitigation and the use of clearing systems.

This recommendation was backed up in April 2009 by a draft directive on 'alternative investment funds', including hedge funds, private equity funds, commodity funds, property funds and infrastructure funds. Under the proposals, funds with assets of more than €100 million would have to meet new levels of transparency towards regulators, investors and other stakeholders, and there would be standard rules on the marketing of hedge funds and private equity across the EU. These proposals provoked a storm of protest in London (where 80 per cent of this sector is said to be based), but they deserver strong support. Another 'Communication' from the Commission, in October 2009, discussed policy on financial derivatives and recommended that they 'shift … from predominantly OTC bilateral to more centralised clearing and trading'.[11] It refers to another piece of work being done by the Commission in the context of Europe's food supply chain 'to ensure that EU agriculture derivatives markets keep their initial purpose of price discovery and hedging'.[12]

Much of this is pulling in the right direction but it meets strong resistance from the U.K. government and, of course, the financial sector in London. London is by far the biggest financial centre in Europe and the government has been willing to back up its demands. But this does not go down well in the rest of Europe, even among those who might be expected to sympathise politically. For example, at Michel Barnier's confirmation hearing at the European Parliament as Commissioner for the Internal Market, a British MEP described himself as 'representing the City of London', but M. Barnier told him brusquely that he ought to be representing his constituents.

A worrying aspect of the EU's policy-making is the role played by 'expert groups' which advise the Commission in drawing up regulations. These are under attack from Corporate Europe Observatory (COE) for being, as it puts it,

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[11] European Commission (2009), 'Communication from the Commission: Ensuring efficient, safe and sound derivatives markets: Future policy actions', document COM(2009) 563 final, Brussels, p. 2, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2009:0563:FIN:EN:PDF.

[12] *Ibid.*, p. 8.

'finance lobbyists in experts' clothing'.[13] For example, a list of the Expert Group on Hedge Funds in 2006 showed 16 members, all of them from the financial services sector, mainly investment banks, hedge funds and other investment bodies. Two of the U.K.'s members were from the most powerful U.S. banks (Goldman Sachs and Morgan Stanley) while one of Ireland's was from the U.S. accountancy firm, PricewaterhouseCoopers. There were also nine observers, representing retail and wholesale investors (four of them), industry, regulators, bank supervisors and two from the corporate lobby, UNICE.[14] Asked about this at his confirmation hearing, Commissioner Barnier replied that 'there are expert groups where it is probably useful or necessary to open up the game' as part of 'the reconciliation of the European market with citizens, consumers, enterprises, trade unions, with the economic and social forces'.[15] M. Barnier must be kept to this commitment. COE has identified four expert groups on Clearing and Settlement, one on Derivatives and two on Payment Systems, among others.

Outside the EU, the International Organisation of Securities Commissions (IOSCO) set up a Task Force on Commodity Futures Markets, which reported in March 2009. However, its recommendations were weak and vague, for example:

> Regulators of commodity futures markets should promote improvements in the availability and quality of information on commodities that are related to commodity futures in order to reduce market uncertainty and to understand the fundamentals driving the market.[16]

4. Policies to curb speculation on food commodities

What policy or regulatory interventions would have the greatest impact on curbing speculation on food commodities? These are all desirable:

- <u>Broaden the legislative remit of commodity market regulation</u> to include excessive price fluctuations and wider economic and social interests, both in the U.K. and in their impacts on other countries.
- <u>Open up and democratise decisions on regulation</u>. This should start with broadening the membership of the European Commission's expert groups. As indicated on p. 7 above, Commissioner Barnier has signalled his sympathy with this ambition.
- <u>Transparency and reporting obligations</u>. This is the first necessity of effective regulation, since otherwise it is not possible for regulators or the public to know what is going on in the markets. The simplest demand is to echo the call of Chris Cook, former compliance director of IPE, for a

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[13] See www.corporateeurope.org/lobbycracy/content/2009/04/finance-lobbyists-experts-clothing.

[14] European Commission (2006), 'Report of the Alternative Investment Expert Group to the European Commission: Managing, Servicing and Marketing Hedge Funds in Europe', p. 38.

[15] 'Vous avez cité des comités qui existent où, probablement, il y a une utilité ou une nécessité d'ouvrir le jeu… la réconciliation du marché européen avec les citoyens, les consommateurs, les entreprises, avec les syndicats, avec les forces économiques et sociales'. Private communication from Yiorgis Vassalos at Corporate Europe Observatory (yiorgos@corporateeurope.org).

[16] IOSCO (2009), 'Task Force on Commodity Futures Markets: Final Report', p. 12.

global registry of all commodity-related spot and derivatives transactions (including both exchange and OTC futures). This must provide full information on trading, including OTC, dark pools and the detailed position on each exchange, including the categories of market participants. Without this information, everyone except market participants are in the dark and no effective regulation can be done. As we will see in the next section, the Commission staff's working document on agricultural derivatives pushes in the right direction here.

- Restrict or prohibit investment funds' (including ETFs') access to commodity markets. A paper written for the FSA in 2007 reported:

  > *'Currently, global pension funds stand at $18.6 trillion Assets Under Management (AUM) of which estimates suggest about $80 billion estimated to be invested in commodities. As many now regard commodities as an asset class, most of our correspondents think all institutional investors should build an exposure of at least 5% (equivalent to $930 billion).'*[17]

  Clearly, that is far more than these markets can absorb. Newman proposes 'an upper limit to the proportion of futures trading conducted by non-commercial actors',[18] to be determined market by market. Broader restrictions on financial investment (especially index funds and ETFs) should be more effective than position limits. Under current rules, UCITS funds are not permitted to invest in physical commodities. That should remain the case and serve as an example for investments in derivatives as well as physicals.

- Effective position limits also need to be introduced, with consistent international enforcement. They can effectively inhibit financial investments. For example, in the U.S. in August 2009 the CFTC removed an exemption from futures position limits in corn and wheat from Deutsche Bank's DB PowerShares funds, which then raised their client fees at a time when ETF fees in general were falling (and those of DB units in Europe were too). This illustrates the power of specific regulations to achieve results in the market, in this case making these funds more expensive and therefore less attractive to investors.

- The U.S. and the U.K. do not regulate the spot markets. But some hedge funds, and others, are now taking delivery of physicals – and not just in gold. This is a form of old-fashioned hoarding, but done by speculative investors, not merchants. Regulations must prevent it.

- Comprehensive regulation of OTC trade, including the clearing of transactions. Any problems can then be traced and handled. This will avoid the sort of mess that was left behind by the bankruptcies of Lehman Brothers and AIG in 2008. It is an illusion that commodity swaps (and most other forms of derivative) eliminate risk, when in fact they merely pass it from bank to bank and so spread it around. This is

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[17] Doyle, E., *et al* (2007), *op. cit.*, p. 23.

[18] S. Newman (2009), 'The New Price Makers: An investigation into the impact of financial investment on coffee price behaviour', NCCR Trade Working Paper No. 2009/7, Bern, www.nccr-trade.org, final paragraph of Conclusion (on an unnumbered page).

why the credit crunch occurred in 2007: far from destroying risk, the mortgage derivatives chopped it up and passed it through so many hands that nobody knew where it was. All banks then feared dealing with any other bank in case its balance sheet was poisoned by these toxic assets.

- Commodity swaps, if permitted at all, should only be created by specialist companies which should be fully regulated as part of the commodities sector, and in which banks can have no interest.
- Impose a financial transactions tax on all financial investments in food commodities, if there is not a complete ban. A precedent was set in the Indian government's 2008-09 budget, which imposed a tax on commodity options and futures, similar to the stamp duty on British share transactions.[19]

More widely, it will be important to follow the lead taken by President Obama in his January 2010 initiative on the banks. At present the most powerful global players on the commodity markets are banks like Goldman Sachs, Morgan Stanley, J.P. Morgan Chase, Barclays Capital and Deutsche Bank. This is not a role that banks should be playing. Their predatory 'internalisation' of transactions must be brought to an end and in future prevented. The domino effect created by their networks of linkages through interbank lending and the derivatives markets was not only the main cause of the 2007 credit crisis (and therefore the banking crash), but is also the principal reason for the banks' political power. Banks are given financial privileges in order that they lend money to the rest of the economy for productive purposes, *not* for the sake of financial engineering, lending to other banks or for that matter the personal enrichment of bankers. They have been allowed to forget that in recent years.

Banks should face the serious prospect of losing their licences if they go beyond this remit (just as do licensees of other activities, such as selling alcohol). *No* banks or parts of banking groups should be allowed to trade as members of a commodity exchange or as brokers placing orders on it, or act as a counterparty on either side of OTC commodity derivatives. Their participation in the commodities sector should be only through the *banking* functions of lending to those who do engage in it, and accepting their deposits.

Banks must be made to return to *banking* - *not* trading, investing or speculating, or owning (in whole or in part) departments or companies that do so, or lending to or borrowing from other banks. All of these functions and interests should be made separate, as they were in the past. Banks too must be kept separate from commodity producers, processors and traders, and all in turn from brokers on the exchanges, in order to avoid concentrations of economic power and conflicts of interest. Transactions and orders should have to be made at arm's length. The motto for banks should be, not 'too big to fail', but 'if too big (or too broad), then *must* fail'.

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[19] *Financial Express*, New Delhi , April 14th, 2008, www.financialexpress.com/news/Futures-caused-the-market-manipulation/296336/0.

As a first step – and as already proposed by President Obama - no proprietary trading (on their own account) should be permitted to any deposit-taking banks. This must be required on a 'consolidated' basis covering complete banking groups (e.g. Barclays worldwide), and preferably enacted at EU level – in concert with the U.S. doing the same for Goldman Sachs, J.P. Morgan etc. EU or U.K. branches of other banks (e.g. from Switzerland, Japan) should be likewise restricted.

Quite a few other measures are needed for food security and the problems of developing countries' export commodities. We need to restore in the EU and the U.K. (and permit or encourage worldwide) other agricultural policies which would lead to more stable prices and reduce reliance on commodity exchanges, even for price-setting or hedging. There is less need to hedge when prices are more predictable. Goverments would play the main role in ensuring this – as they did in Western Europe and elsewhere from the 1940s to the early 1980s. But these are not topics for this campaign.

5. Implementation of reforms

The possibility of achieving change is real, not only because of the continuing economic crisis but the political changes due under a British general election and a new European Commission. These provide the opportunity for a shake-up in commodities regulation if, as seems likely, the Conservatives win the election and want to change the wider regulatory set-up. It might be appropriate to put banks back under the oversight of the Bank of England, as the Conservatives propose, but not the commodity markets. This might make it easier to press for a specialist agency with the skills and powers required, like the CFTC in the U.S. If another party wins, a similar change can still be advocated as part of a necessary clarification and strengthening of regulatory powers, which would be better implemented independently of the FSA.

The establishment of a new European Commission provides similar opportunities in EU regulation. Michel Barnier, Commissioner for the Internal Market, must be pressed on the regulation of commodity markets, in *investors'* interests as well as those indirectly affected in developing countries and elsewhere. And the Commission has already initiated action. It has published several relevant 'Communications' accompanied by staff working papers,[20] engaged in consultations and is preparing directives on some of these issues for publication in 2010. The Council and European Parliament have also made some positions known, although they are usually reactive on Commission proposals. But it is the EP's majority that is likely to take the strongest line in insisting on stronger, more formal regulation. There is a vocal, largely British opposition to this, but it is quite a small minority of the EP and it should be easily contained. However, its existence (in the EP and in domestic debates) must be taken into account in all campaign preparations. There will also be 'trialogues' between the three institutions, leading (it is

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[20] A useful list of these and other relevant documents can be found in Annex II, p. 26 of European Commission (*op.cit.*, 2009).

intended) to consensus, or at least negotiated agreements, on the measures to take.

Tense discussions have been reported on the Alternative Investment Funds proposals in the Council of Ministers, with the U.K. in virtually a minority of one (but a powerful and determined one). These are probably a foretaste of other regulatory clashes. It is not just that the U.K.'s political and financial élite is against formal regulation, but the government is jealous to keep everything to do with the City's markets to itself. However, its actual power is not what it was. It had to yield to CFTC's pressure over position limits in oil futures trading, and the extension of the EU's internal market to financial services means it has to accept some role for the EU to determine regulations too. The U.K.'s bargaining power is further weakened by the way the crisis has gone, both in showing up the weaknesses of the hands-off approach to regulation and demonstrating a general economic vulnerability. (With the exception of Greece, the weakest among the other member states are those which followed the U.K. model most closely, such as Ireland and Latvia.)

Within the U.K., much will be up for grabs after the general election, especially if the Conservative Party wins it, in view of its desire to change (yet again) the regulatory institutions. Besides handing bank regulation back to the Bank of England, the Conservatives are more open than New Labour to the need to constrain banks' behaviour – maybe born of their closer knowledge of how finance and business operate, and greater self-confidence in handling them. However, their instinct for the commodity markets will probably be to change and regulate as little as they can, unless they are put under strong public pressure. That pressure might be easier to generate, and more likely to achieve a response, if it starts from the financial side (e.g. preventing 'investment' in food products and their markets, and pulling the banks away from commodities trading) rather than directly in the arcane business of regulating derivatives.

The main domestic *mechanisms* of change will, as ever, be through pressure on government legislation and parliamentary activity (such as Early Day Motions to get an issue launched).

Appendix

Goals of U.S. campaigns on commodity market reform

Here are two definitions of campaign aims for commodity market reform which came out of the U.S. over the last year.

Note the fifth item in the first of them: 'Ban exchange traded funds and other financial instruments from investing in physical commodities and their derivatives.'

1. We urge Congress to work swiftly and approve legislation that will:

- Address market activity for all commodities, including energy, agriculture, livestock and metals;
- **Fully close the "Enron Loophole"** by requiring that large over-the-counter trades comply with data reporting requirements and are made subject to speculative position limits;
- **Close the so-called "Foreign Markets Loophole"** or "London Loophole" by requiring the presence of foreign regulators with comparable oversight in order for an off-shore exchange to obtain regulatory exemptions (i.e., no-action letters);
- **Close the "Swaps Loophole"** by limiting hedging exemptions to *bona-fide* commercial participants and requiring that swap traders, index funds and institutional investors comply with all CFTC speculation limits and data reporting requirements;
- **Ban exchange traded funds and other financial instruments** from investing in physical commodities and their derivatives;
- **Require across-the-board aggregate speculation limits** to prevent traders from taking a controlling position in a commodity by taking large positions on multiple platforms;
- **Require the CFTC to review all current regulatory exemptions** and require Commissioners to withdraw them as appropriate, or in accordance with existing or new authorities granted by Congress;
- **Require a thorough review, with recommendations, of all new and existing rules and regulations** designed to protect market users and the public from fraud, manipulation and excessive speculation, including position limits, margin requirements, data reporting requirements, and public availability of data;; and
- **Require a study of newly emerging environmental markets**, emissions trading and related Wall Street products and instruments, including derivatives, index funds and exchange traded funds.

2. Our proposed solutions

Commodity Market Reform Asks

What we are looking for in terms of reforms are ways to avoid systemic risk, address excessive speculation in commodity markets, avoid fraud and manipulation, and remove or greatly reduce index speculation in commodities.

1) To avoid systemic risk (another meltdown):

All derivatives in a market above a certain threshold amount should AT LEAST clear through an exchange or clearinghouse. This would include commodities, credit default swaps, everything. Exchange clearing would provide transparent reporting of the majority of futures contract trades that currently occur off market and would require the posting of collateral. The best possibility however, is to require them to be traded through an exchange. All swaps that can trade on an exchange should be required to do so. Exchange trading would provide full, real-time price transparency for regulators and market participants and also more fully eliminate systemic risk. For the limited number of contracts that are too customized to clear, they should be subject to set-aside requirements.

2) To avoid excessive speculation in commodity markets:

Restore speculative position limits for all commodities speculators. Limits for commodities must reflect their special status as the essentials of life meaning that S&P 500 futures limits should be set to prevent manipulation but corn futures limits must be set to help prevent not just fraud and manipulation, but also excessive speculation in order to prevent another bubble in food and energy commodities.

These limits must be aggregated between all the CFTC and SEC-regulated markets, unregulated foreign exchanges and over-the-counter (OTC) markets in order to prevent speculators from venue shifting to the least regulated markets. Index investors, who almost exclusively buy commodities as long term investments, and not as a hedging measure, resulting in a greater distortive effect, should have the strongest position limits.

These measures would help prevent any future commodities bubbles from forming. Physical (bona fide) hedgers would continue not to have position limits unless their holdings greatly exceed their physical operations in commodities.

3) To avoid fraud and manipulation:

Senator Cantwell's Derivatives Market Manipulation Prevention Act of 2009 would make it possible for federal regulators to more effectively investigate and punish market manipulation in commodity futures and derivatives markets. Currently, the CFTC, that regulates the commodities markets, has to prove that speculators had specific intent to do harm rather than using the recklessness standard, used by the SEC for the past 75 years. Specific intent is a much more difficult standard to prove. In fact, the standard is so weak that in its 35-year history, the CFTC has successfully prosecuted and won only one case of manipulation in the futures markets. The bill would allow the CFTC to prosecute by proving that speculators acted recklessly.

4) To reduce index speculation in commodities

Support Senator Wyden's Stop Taxbreaks for Oil Profiteering Act (S1588) that makes all players in commodity futures markets pay the same level of taxes. Currently, those who use commodity futures markets as they were planned (farmers, granaries, mills, etc.) pay short term capital gains taxes (15-35%) on any income from those markets. But hedge funds and other financial institutions that buy and hold commodities futures only pay long term capital gains taxes (currently 15%) on their profits from these markets. This gives them an unfair advantage. An even larger benefit is given to tax-exempt funds like endowments and pension funds that pay no taxes whatsoever on their profits from commodity investments.

The Stop Taxbreaks for Oil Profiteering (STOP) bill (S1588) will make all people investing in commodity futures markets pay the same taxes. By doing this, it will drastically reduce the amount of money that big time investors will put into commodity markets because they will earn more and pay less in taxes by investing elsewhere.

Wyden's bill currently only includes oil and natural gas commodities, but could be improved by including food commodities too. This bill has a good chance of passing because similar laws have been passed in other markets.