17 January 2022

Public Comment on the Principles for the Regulation and

Supervision of Commodity Derivatives Markets

FIA Response

FIA[1] welcomes the opportunity to provide feedback to The Board of the International Organization of Securities Commissions (IOSCO) on proposed revisions to its *2011 Principles for the Regulation and Supervision of the Commodity Derivatives Markets ("Principles").*

Summary:

FIA supports IOSCO's intentions to revise and update the Principles to ensure that commodity derivatives markets continue to facilitate price discovery and hedging, while remaining free from manipulation and abusive practices. As noted in the consultation, commodity derivatives markets have developed and evolved significantly over the past decade.

A principles-based approach to regulation provides regulators with outcomes-based tools that can be tailored to an ever-changing global marketplace driven by technology. Principles allow regulators to focus on the risk of activities across a broad array of market participants and products and readily respond to changing market dynamics.

Generally, FIA believes the revised Principles reflect changes, trends and activities in the commodity derivatives markets over the last decade, since the publication of the original Principles in 2011, and continue to serve as a sound framework to guide oversight for the regulation of commodity derivatives markets. FIA believes there are certain areas that merit additional IOSCO consideration and would like to offer some recommendations to improve and clarify certain updated principles.

Additionally, FIA notes that Principle 6 of the consultation report references the Principles for Oil Price Reporting Agencies, Final Report of the IOSCO Board[2], which was released in October 2012. It may be appropriate to reevaluate these principles since they were developed specifically for oil markets, and

[1] FIA is the leading global trade organisation for the futures, options and centrally cleared derivatives markets, with offices in Brussels, London, Singapore and Washington, D.C. FIA's membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from more than 48 countries as well as technology vendors, lawyers and other professionals serving the industry. FIA's mission is to support open, transparent and competitive markets, protect and enhance the integrity of the financial system, and promote high standards of professional conduct. As the principal members of derivatives clearinghouses worldwide, FIA's member firms play a critical role in the reduction of systemic risk in global financial markets.

[2] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD391.pdf

other physical commodities may have different characteristics (including how pricing data is shared, aggregated, and reported) that may warrant additional consideration.

Recommendations:

The final report should set out more definitively that the Principles apply principally to exchange-traded derivatives on a physical commodity or a non-financial deliverable with a finite supply. FIA understands this to be the intent based on reading the Principles as a whole, but certain statements introduce ambiguity. More study is needed to determine whether any of the Principles should be applied to derivatives on intangible commodities such as carbon credits.

FIA agrees with IOSCO's statement, at page 9, that " [t]he Principles are intended to apply primarily to exchange-traded futures contracts, options on futures contracts and options, for which the underlying reference interest is a physical commodity or physical commodity index or price series and which may settle in cash or by physical delivery." Accompanying this clear statement of the Principles' scope is another statement that reads: "Although, in some cases, the Principles could also be applied to contracts where the underlying interest is a financial instrument or an intangible (e.g., carbon credits)." While this language appears to have been pulled from the 2011 Principles, we believe it confuses the core assertion that the Principles principally apply to "contracts based on a physical commodity or a non-financial deliverable with finite supply." We recommend removing the above-referenced sentence beginning with "Although,…" or alternatively we recommend replacing it and the sentence that follows with a combined sentence that reads: "Although it may be appropriate to apply certain of the Principles to derivatives contracts where the underlying interest is a financial instrument or an intangible, the Principles are directed to contracts based on a physical commodity or a non-financial deliverable with finite supply." We make this request with the health and continued growth of the voluntary carbon markets principally in mind.

Application of the Principles to this class of exchange-traded derivatives (and indirectly to the underlying cash carbon credit markets) could inhibit the growth of these important markets. Regulators and industry participants are presently working in a number of jurisdictions and international bodies to develop standards for emerging environmental products, carbon products chief among them. Broad application of these Principles--at least at this time--to derivatives on carbon credits, as well as other intangible underliers, could disrupt these ongoing work streams, which notably have been structured to consider the specific features of carbon markets. The same can be said for derivatives on digital assets, which may also be captured by references to "intangible" commodities.

Further study is needed before the Principles, whether in whole or in part, are applied to contracts beyond what market participants commonly consider to be exchange-traded physical commodity derivatives, which is to say what IOSCO otherwise clearly defines as futures, options on futures and options contracts based on a physical commodity or a non-financial deliverable with finite supply.

In particular, insofar as carbon markets are concerned, this could be done in a more informed and deliberate manner after the further development of standards for environmental contracts across the globe, and via a separate consultation with the industry and other stakeholders.

Principle 2 should ensure the trading dynamics of commodity derivative dealers are acknowledged and observed across regulatory capital regimes.

The vast majority of commercial and other swap dealers making OTC markets offset their risk via on-exchange contracts. To differing degrees, various regulatory capital regimes do not acknowledge this common trading structure, and only enable market risk charges to be reduced where OTC swap transactions are offset by other OTC products. Consequently, when hedging via on-exchange futures or options products, some dealers face twice the regulatory capital charge, thereby discouraging hedging activity in a manner that increases price and liquidity risk to commodity markets (financial and real). FIA encourages IOSCO to clarify Principle 2 to ensure the trading dynamics of commodity derivative dealers are acknowledged and observed across regulatory capital regimes. FIA encourages IOSCO to aid in the adjustment of any regulatory capital regime that inadvertently presents liquidity and high price risks and costs to dealers, producers, merchants and customers by disregarding and even penalizing the legitimate hedging activities of OTC commodity dealers.

Principle 16 should make clear that government authorities should intervene to address disruptions in commodity derivatives markets only as absolutely necessary after it becomes clear the market operator or self-regulatory organization will not be able to implement measures to restore proper functioning of the market.

The Covid pandemic and ensuing market volatility in the Spring of 2020 provided a real-world stress test of our markets following the implementation of post-financial crisis reforms. While there have certainly been lessons learned and areas identified for improvement, market participants (including clearing firms, central counterparties, and others) remained in close contact with government authorities. Having an open line of communication between market participants and government authorities was important during the volatile market conditions in the Spring of 2020 and ensuing months.

FIA members have concerns, however, about potential government authority intervention during times of market stress and volatility, as seemingly contemplated in Principle 16. We believe this principle needs to be clarified to ensure that government authority intervention (no matter how broadly defined) occurs only as absolutely necessary after it becomes clear the market operator or self-regulatory organization will not be able to implement measures to restore proper functioning of the market.

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In addition to clarifying the sequence of appropriate intervention by governmental authorities, IOSCO would do well to clarify, where relevant, which principles apply to each category of market authority (e.g., governmental regulator, self-regulatory organization, or operator of the regulated market).

Conclusion:

FIA supports IOSCO's intentions to revise and update the Principles to ensure that commodity derivatives markets continue to facilitate price discovery and hedging, while remaining free from manipulation and abusive practices.

FIA believes the revised Principles generally reflect changes, trends and activities in the commodity derivatives markets over the last decade. We appreciate the hard work that went into this project and appreciate the opportunity to provide some recommendations to further enhance and clarify these Principles.

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