

Tokyo Commodity Futures Markets Regulators' Conference

October 1997



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Tokyo Communiqué on Supervision of Commodity Futures Markets

REPRESENTATIVES OF REGULATORY AUTHORITIES FROM 16 JURISDICTIONS RESPONSIBLE FOR SUPERVISING COMMODITY FUTURES MARKETS (COLLECTIVELY “THE AUTHORITIES”) MET ON OCTOBER 30 AND 31, 1997, IN TOKYO, JAPAN TO EVALUATE THEIR WORK OVER THE PREVIOUS YEAR IN ADDRESSING THE OVERSIGHT OF COMMODITY FUTURES MARKETS AND, TOGETHER WITH CERTAIN SUPPORTING AUTHORITIES, ISSUED THE FOLLOWING

TOKYO COMMUNIQUÉ ON SUPERVISION OF COMMODITY FUTURES MARKETS

1. **THEY ANNOUNCED** completion of the comprehensive one-year work program set forth in the London Communiqué issued in November 1996 by the Authorities at a meeting in London. The London meeting had been convened in response to concerns that:¹

¹ See the London Communiqué, in which the Authorities who met in London in November 1996 set out their proposals for strengthening the oversight of commodity futures markets, in particular in the areas of contract specifications, market surveillance, and information sharing. Other Communiqué objectives included: the conduct of surveys in the areas of contract design and market surveillance; the designation of contact persons to communicate surveillance information; the encouragement of participation in the international regulatory summary compiled by the US Commodity Futures Trading Commission (“CFTC”) and maintained by the International Organisation of Securities Commissions (“IOSCO”); the amendment of the Declaration on Cooperation and Supervision of International Futures Exchanges and Clearing Organisations (“Boca Declaration”) to permit all Authorities to become signatories; and the support of efforts of others to prioritize information which market authorities may share during specific market events.

- no other forum had addressed the international supervisory implications for market integrity and confidence in the markets for commodity contracts which are based on an underlying physical commodity and which settle in cash or by physical delivery;
- the increasingly global nature of commodity pricing, production, storage and delivery and the diverse regulatory treatment of these markets compounded the potential for market integrity and confidence issues; and
- manipulative or other abusive activities damage the integrity and ultimately the liquidity of a market.

2. **THE AUTHORITIES** again considered:

- the interlinkages among markets, including cash and over-the-counter markets, and the multinational nature of global trading firms;
- the susceptibility of markets to economic shocks, currency instability, failures of supply, potential manipulative or other abusive activities, and firm financial distress; and
- the particular supervisory needs of physical delivery markets,²

AND TOOK ACCOUNT OF the responses to two surveys conducted by the authorities who participated in the London meeting concerning current practices related to contract design and information sharing and surveillance³ and the Authorities' preliminary conclusions which were published at a meeting in London in June 1997.⁴

² This Communiqué is intended to address futures contracts, options on futures contracts and options for which the underlying interest is a physical commodity or a non-financial deliverable with finite supply.

³ The Authorities carried forward the London Communiqué work program primarily through two working groups, one on contract design chaired by the CFTC and the other on market surveillance and information sharing chaired by the UK Financial Services Authority ("FSA," formerly the Securities and Investments Board) and the Ministry of International Trade and Industry ("MITI") and the Ministry of Agriculture, Forestry and Fisheries ("MAFF") of Japan. Recognizing that there was incomplete knowledge concerning contract design and market surveillance practices internationally, the two groups conducted comprehensive surveys of the Authorities to determine current approaches. The regulators' survey was complemented by the work of the Subcommittee of the Consultative Committee of IOSCO ("Consultative Subcommittee") which separately conducted its own surveys and provided comment to the working groups. See *Collation of responses received from regulatory authorities to the surveys on contract design, market surveillance and information sharing (June 1997)*.

⁴ See *Interim Report from the Co-Chairs of the November 1996 London Commodity Futures Markets Conference: Results of Surveys on Contract Design, Market Surveillance and Information Sharing (June 1997)*; and *London Communiqué Project: Subcommittee of the London Communiqué of the Consultative Committee of IOSCO (May 1997)*.

3. THEY CONCLUDED THAT MARKET AUTHORITIES SHOULD:

- Set benchmarks through guidance on best practices.
- Assure accountability of market authorities⁵ at every level, regulatory, self-regulatory and exchange.
- Assure adequacy and timeliness of regulatory and supervisory information to assess the risks of market participants' whole position and consequent exposures, recognizing that information on related cash and over-the-counter positions may be less accessible than information on positions in centralized exchange markets.
- Assure clarity of rules of the market and their application through surveillance, cross border cooperation, intervention and disciplinary techniques.
- Assure adequacy of market authorities' powers to address abusive practices, including the ability of a competent authority to address undesirable conduct by non-members of the market.

4. THE AUTHORITIES THEREFORE:

- Welcomed the work on contract design and market surveillance and information sharing.
- Endorsed the *Guidance on Standards of Best Practice for the Design and/or Review of Commodity Contracts and the Guidance on Components of Market Surveillance and Information Sharing ("Guidance Papers")*.⁶

⁵ The term "market authorities" for purposes of this Communiqué means the regulator of the market, whether on-exchange or OTC, and could be a government body, self-regulatory organisation or an exchange or several of these. "Government body" could include a public prosecutor or the courts.

⁶ Attached at Annexes A and B.

5. **THE AUTHORITIES SPECIFICALLY CONCLUDED WITH RESPECT TO CONTRACT DESIGN** that the following standards of best practice (as more fully articulated in the *Guidance on Standards of Best Practice for the Design and/or Review of Commodity Contracts*) should be taken into consideration by market authorities in the design and/or review of commodity contracts, **recognizing that** the manner in which these standards are applied to any given contract may vary to reflect the diversity of commodities underlying futures and option contracts and the evaluation methodologies used:

- **Accountability:** the competent market authority should establish a clear framework as to design and review criteria or procedures. Market authorities should be accountable for compliance with statutory and/or self-regulatory standards and should retain powers to address and where necessary to vary the provisions of existing contracts which produce manipulative or disorderly conditions. At a minimum a market authority with governmental powers should have legal or statutory powers to address contract provisions which produce manipulative or disorderly conditions.
- **Economic Utility:** contracts should meet the risk management needs of potential users and/or promote price discovery of the underlying commodity.
- **Correlation with Cash Market:** contract terms and conditions generally should, to the extent possible, reflect the operation of the underlying cash market and avoid impediments to delivery.
- **Settlement and Delivery Reliability:** settlement and delivery procedures should reflect the underlying cash market and promote price convergence.
- **Responsiveness:** the views of potential market users should be taken into account in designing commodity contracts.
- **Transparency:** information concerning the contract's terms and conditions, as well as other relevant information concerning delivery and pricing, should be readily available to market authorities and to market users.

The Authorities further concluded that contract design standards are a complement to, but not a substitute for, an appropriate market surveillance system.

6. **THE AUTHORITIES SPECIFICALLY CONCLUDED WITH RESPECT TO MARKET SURVEILLANCE AND INFORMATION SHARING** that the following standards of best practice (as more fully articulated in the *Guidance on Components of Market Surveillance and Information Sharing*) should be reviewed and applied by market authorities, **taking into account** differences in powers of market authorities and the regulatory powers of each jurisdiction in undertaking market surveillance and the sharing of information:
- **Framework for Undertaking Market Surveillance:** each commodity futures market and other market authorities should have a clear framework for conducting market surveillance, compliance and enforcement activities and there should be oversight of these activities.
 - **Access to and Collection of Information:** information should be collected on a routine and non-routine basis for on-exchange and related cash and over-the-counter (“OTC”) markets and should be designed to assess whether the market is functioning properly. Market authorities should have access to information that permits them to identify concentrations of positions and the composition of the market. It is acknowledged that data on related cash and OTC markets may be less immediately available than data for exchange markets. This may be an area which requires governmental powers.
 - **Analysis of Information:** analysis of information should be suitable for the type of information collected and both collection and analysis of information should occur speedily.
 - **Intervention Powers in the Market:** effective powers should be available to intervene in the market to prevent or to address abusive practices or disorderly conditions and there should be clarity as to the types of intervention which could occur.
 - **Disciplinary Sanctions Against Members of the Market:** effective powers should be available to discipline market members and there should be clarity as to the types of possible disciplinary action.
 - **Non-members of the Market:** the relevant authority should have the power to address the abusive actions of non-members of the market.
 - **Information sharing:** market authorities should cooperate to share information, in particular information on large exposures. Information obtained should be handled confidentially. Information obtained should be used solely for carrying out the supervisory responsibilities of the relevant authority and as specified in the request for information.

7. THE AUTHORITIES ALSO ANNOUNCED

(a) With respect to enhancement of international information sharing:

- The amendment of the Boca Declaration to permit execution by commodity authorities previously restricted from signing.

(b) With respect to enhancement of cooperation and sharing of information during market events:

- The maintenance of an emergency contact list by the Authorities listing for each Authority contact persons responsible for the sharing of surveillance and delivery information during a market or firm event and their agreement to keep such list current.
- The support of current efforts by other international forums to categorise and to prioritise the information which market authorities may wish to share during specific market events, thereby facilitating international information sharing.⁷

(c) With respect to enhancement of transparency of market practices and procedures:

- The addition of new information on contracts, rules and procedures of commodity markets in the 1997 edition of the regulatory summary *International Regulation of Derivative Markets and Financial Intermediaries* and their agreement to keep such information current.⁸

⁷ See the proposed IOSCO publication: *Guidance on Information Sharing* (pending November 1997).

⁸ This summary is available freely on the website of IOSCO [<http://www.iosco.org>].

8. **THE AUTHORITIES MADE THE FOLLOWING RECOMMENDATIONS**

(a) With respect to the Guidance Papers on contract design and components of market surveillance and information sharing, that market authorities:

- Examine their current practices with respect to the design or review of commodity contracts to determine the extent to which those practices take into account the standards of best practice set forth in the *Guidance on Standards of Best Practice for the Design and/or Review of Commodity Contracts*.
- Review their market surveillance and information sharing arrangements and seek to ensure that the *Guidance on Components for Market Surveillance and Information Sharing* is put into effect.
- Commend the consideration of standards of best practice set forth in the Guidance Papers to the relevant markets in their jurisdictions and to market authorities with responsibilities for the supervision of commodity markets generally.

(b) With respect to international information sharing

- That market authorities be encouraged to participate in and to make use of the arrangements for sharing information which are set out in the Boca Declaration.

(c) With respect to transparency of market practices and procedures

- That market authorities take steps nationally to encourage commodity markets and clearing houses to make their rules and procedures for trading and delivery of commodity contracts and the manner of their application transparent and clear.

(d) Furthermore, in view of the fact that information is a critical tool for maintaining fair and orderly markets and ensuring market integrity in non-financial physical delivery markets with finite supply, that market authorities should seek the removal of domestic legal or other barriers to ensure, consistent with the regulatory framework of each jurisdiction, access by market authorities to information that permits them to detect and to deter abusive practices and disorderly conditions in the markets, including access to information that permits them to identify concentrations of positions and the overall composition of the market.

9. **THE AUTHORITIES MADE THE FOLLOWING PROPOSALS FOR FURTHER WORK:**

- To consider at the March 1998 international regulators' meeting to be held in Boca Raton, Florida, a proposed amendment to the Boca Declaration to clarify its application to manipulative activities and/or unusual price movements.
- To refer to IOSCO for its consideration:⁹
 - the need to provide further content to the components of surveillance by publishing additional guidance on existing structures and techniques used for the oversight of markets and clearing organizations;
 - further delineation as to what constitutes manipulative activities or abusive practices in commodity futures markets; and
 - the extent to which the standards of best practice set forth in the Guidances can be applied to financial and other derivatives markets.

Issued in Tokyo, Japan on October 31, 1997

⁹ This Communiqué and the contemplated further work complement existing IOSCO guidelines. See, for example, IOSCO publications: *Principles for Memoranda of Understanding* (September 1991); *Mechanisms to Enhance Open and Timely Communication Between Market Authorities of Related Cash and Derivative Markets During Periods of Market Disruption* (October 1993); *Report on Cooperation Between Market Authorities and Default Procedures* (March 1996); and the proposed *Guidance on Information Sharing* (pending November 1997).

ADHERENTS TO THE TOKYO COMMUNIQUÉ

AUSTRALIA

Australian Securities Commission

BRAZIL

Comissão de Valores Mobiliários

CANADA

Canadian Grain Commission

FRANCE

Commission des Opérations de Bourse

GERMANY

Bundesaufsichtsamt für den Wertpapierhandel

HONG KONG

Securities and Futures Commission

HUNGARY

Hungarian Banking and Capital Market Supervision

ITALY

Commissione Nazionale per le Società e la Borsa

JAPAN

Ministry of International Trade and Industry

Ministry of Agriculture, Forestry and Fisheries

KOREA

Ministry of Finance and Economy

MALAYSIA

Securities Commission

NETHERLANDS

Securities Board of the Netherlands

SINGAPORE

Singapore Trade Development Board

SOUTH AFRICA

Financial Services Board

UNITED KINGDOM

Financial Services Authority

UNITED STATES OF AMERICA

Commodity Futures Trading Commission

Annex A: Guidance on Standards of Best Practice for the Design and/or Review of Commodity Contracts

Introduction

In November 1996 regulatory authorities and representatives from seventeen countries responsible for the regulation of many of the world's leading commodity futures markets met in London to discuss proposals to develop and to strengthen arrangements and practices for the supervision of these markets. They published the outcome of their discussions in a communiqué (the "London Communiqué" or "Communiqué") which set out their proposals for strengthening the oversight of commodity futures markets internationally.

The London Communiqué recognized that commodity contracts which are based on an underlying tangible commodity, whether settled in cash or by physical delivery, may have characteristics different from highly liquid financial futures contracts. This is particularly the case when supply is limited.

The Communiqué noted that the proper design of the terms and conditions of commodity contracts reduces the susceptibility of such contracts to market abuses, including manipulation, and concluded that the consideration of

appropriate contract design principles by market authorities¹ complements surveillance and is a critical aspect of market integrity.

The Communiqué further noted that proper contract design also enhances the economic utility and commercial success of commodity contracts.

With respect to contract design, the London Communiqué called for the development of standards of best practice for the design and/or review of commodity contracts.²

During the early part of 1997 a survey of contract design practices was undertaken across the seventeen countries that had issued the London Communiqué. The results of the survey were published in June 1997 and discussed by regulators attending the London International Derivatives Week Conference. Simultaneously, the report of the Subcommittee on the London Communiqué of the Consultative Committee of the International Organisation of Securities Commissions (“IOSCO”)³ on commodity contract design was published and considered.

The parties to the London Communiqué agreed to set up a working party⁴ to develop formal guidance on standards of best practice for the design and/or review of commodity contracts. This paper sets out that guidance as a statement of best practice.

Regulators discussed the draft guidance at the Burgenstock Conference in September. Following further consultation and discussions, final guidance was published at the Tokyo Commodity Futures Regulators’ meeting in October 1997.

The standards of best practice set forth herein should be considered by market authorities in the design and/or review of commodity contracts,

1 For purposes of this Guidance, the term ‘market authority’ may refer to a governmental regulator, a self-regulatory organization or an exchange.

2 For purposes of this guidance, the term “commodity contract” refers to futures contracts, options on futures contracts, and options for which the underlying reference interest is a physical commodity. Although, as relevant, this guidance could also be applied to contracts where the underlying interest is a financial instrument, this guidance is directed to contracts based on a physical commodity or a non-financial deliverable with finite supply. Additionally, the guidance is intended to apply to exchange-traded derivatives products and is not directed to over-the-counter products.

3 The Subcommittee was formed to offer assistance from futures exchanges and other futures industry self-regulatory organizations to government regulators participating in the London Communiqué work program. The Subcommittee published its *Response to the Survey of Opinion Regarding Best Practices for Terms and Conditions of Commodity Contracts and Over-the-Counter (OTC) Commodity Futures Activity (Market Surveillance)* on May 30, 1997.

4 The working party was chaired by the Commodity Futures Trading Commission (US) and comprised certain participants from the London Conference.

recognizing that the manner in which these standards are applied to any given contract may vary to reflect the diversity of commodities underlying futures and option contracts and the evaluation methodologies used.

Statement of Intent

This guidance should be read in light of the following:

Authority, Process and Level of Supervision Not Addressed

This guidance does not prescribe what type of market authority – whether an exchange, another self-regulatory organization or governmental authority – should be responsible for the design and/or review of commodity contracts or the process by which such contracts are designed or approved. In any event, the exchange typically will be accountable for contract design regardless of the regulatory review process.

Rather, the intent of this guidance is to ensure that the relevant market authority takes into account the standards of best practice discussed in this guidance in exercising its design and/or regulatory review functions.

Design Standards Complement And Are Not A Substitute for Market Surveillance

Contract design standards should be viewed as a complement to and not a substitute for an appropriate market surveillance system.⁵

Even well-designed contracts can be subject to manipulation or price distortion, and appropriate market surveillance is critical to ensure market integrity.

Standards of Best Practice

- **Accountability:** the competent market authority should establish a clear framework as to design and review criteria or procedures. Market authorities should be accountable for compliance with statutory and/or self-regulatory standards and should retain powers to address and where necessary to vary the terms of existing contracts which produce

5 See Guidance on *Components of Market Surveillance and Information Sharing*.

manipulative or disorderly conditions. At a minimum a market authority with governmental powers should have legal or statutory powers to address contract provisions which produce manipulative or disorderly conditions.

- **Economic Utility:** contracts should meet the risk management needs of potential users and/or promote price discovery of the underlying commodity.
- **Correlation with Cash Market:** contract terms and conditions generally should, to the extent possible, reflect the operation of the underlying cash market and avoid impediments to delivery.
- **Settlement and Delivery Reliability:** settlement and delivery procedures should reflect the underlying cash market and promote price convergence.
- **Responsiveness:** the views of potential market users should be taken into account in designing commodity contracts.
- **Transparency:** information concerning the contract's terms and conditions, as well as other relevant information concerning delivery and pricing, should be readily available to market authorities and to market users.

Discussion

- **Accountability – The competent market authority should establish a clear framework as to design and review criteria or procedures. Market authorities should be accountable for compliance with statutory and/or self-regulatory standards and should retain powers to address and where necessary to vary the provisions of existing contracts which produce manipulative or disorderly conditions. At a minimum a market authority with governmental powers should have legal or statutory powers to address contract provisions which produce manipulative or disorderly conditions.**

Irrespective of which entity designs and/or reviews a commodity contract, the framework governing such process should be clear, and the relevant market authority should be accountable for compliance with relevant statutory and/or self-regulatory organization standards.

The relevant market authority should retain powers to address and where necessary to vary the provisions of existing contracts which produce manipulative or disorderly conditions.

In addition, at a minimum a market authority that exercises governmental powers should have legal or statutory powers to address contract provisions which produce manipulative or disorderly conditions by appropriate intervention action taking account of the circumstances.⁶ In this regard, nearly all respondents to the survey on contract design indicated that, whether or not they exercised approval authority in respect of initiation of a contract, they could exercise authority to suspend or to terminate trading in a contract based on market integrity concerns. It also should be noted that the mere presence of price volatility does not constitute a disorderly market.

- **Economic Utility – Contracts should meet the risk management needs of potential users and/or promote price discovery of the underlying commodity.**

The design or review of commodity contracts should include a determination that the contract can meet the risk management needs of potential users and/or promote price discovery of the underlying commodity.

The determination of economic utility may be implied – for example, from an analysis of the cash market.

The more accurately a commodity contract reflects the operation of the relevant cash market, the greater likelihood of its economic utility as a tool for hedging⁷ and price discovery.

- **Correlation with Cash Market⁸ – Contract terms and conditions generally should, to the extent possible, reflect the operation of the underlying cash market and avoid impediments to delivery.**

The price of a futures contract at expiration should reflect the value of the underlying cash commodity as specified in the terms of the futures contract, plus or minus the costs associated with making or taking delivery. For physical delivery contracts, the possibility of delivery is the market force that usually causes convergence of cash and futures markets at expiration.

Futures markets increasingly become susceptible to nonconvergence of cash and commodity prices, price disorder or manipulation when there are impediments to making or taking delivery.

6 Actions affecting open positions (see *Guidance on Components of Market Surveillance and Information Sharing*) should be designed to minimise any impact on market operations.

7 For purposes of this guidance, the term “hedging” refers to the taking of a position in a commodity contract opposite to a position held in the cash or OTC market to minimize the risk of financial and/or economic loss from an adverse price change or otherwise for risk management purposes. Conduct that is described as permissible hedging activities may differ among jurisdictions.

8 For purposes of this guidance, the term “cash market” refers to the market for trading of the product underlying the commodity contract.

Such impediments may be related to the inherent nature of the commodity (size of deliverable supply or seasonality of the commodity) or to the mechanics of the delivery process (e.g., transportation requirements, costs of inspection).⁹

A high correlation between cash market prices and futures market prices may be achieved by designing the futures contract with terms and conditions which conform to the prevailing cash market commercial practices of the commodity underlying the futures contract.

Accordingly, commodity contracts generally should, to the extent possible, be designed to conform to prevailing cash market commercial practices and to avoid impediments to delivery in order to reduce the likelihood of nonconvergence of cash and commodity prices, manipulation or a disorderly market. Deviations from cash market practice (which may at times be necessary) should be analyzed in light of their likely impact on orderly trading and price convergence.

Market authorities should consider, without limitation, the following cash market characteristics in designing and/or reviewing commodity contracts:¹⁰

1. Size and structure of the cash market.
2. Historical patterns of production, consumption and supply, including seasonality, growth, market concentration in the production chain, domestic or international export focus.
3. Extent of distribution (dispersal) of production and consumption of the cash commodity among producers, merchants and consumers.
4. Adequacy, nature and availability of supply of the cash commodity.
5. Quality or grade of cash commodity.
6. Movement or flow of cash commodity.
7. Liquidity of the cash market.

⁹ Cases of *force majeure* affecting delivery should be addressed by surveillance programs (see *Guidance on Components of Market Surveillance and Information Sharing*).

¹⁰ For example, an exchange may determine to impose more rigorous standards where cash market practices are relatively informal. Exchanges also may offer their own dispute resolution procedures that differ from cash market conventions. Also, additional or different considerations may apply to flex or other contracts that provide less standardized, OTC-like options; this guidance is not intended to restrict such innovations.

8. The cash pricing system including transparency, availability and frequency of cash pricing.
 9. Price volatility.
 10. The existence of price controls, embargoes or other regulation or controls affecting the price or supply of the cash market commodity.
- **Settlement Reliability – Settlement and delivery procedures should reflect the underlying cash market and promote price convergence.**

Whether settlement is by cash or by physical delivery, the settlement procedures should reflect the underlying cash market to promote reliable pricing relationships and cash/futures price convergence and to ensure that the contract is not readily susceptible to manipulation.

1. Cash settlement

For contracts which are cash settled, considerations should include an analysis of the reliability of the cash commodity reference price on which pricing of the contract is based, public availability and timeliness of pricing information, liquidity of the cash market and the potential for price manipulation or distortion of the price used for cash settlement.

2. Physical delivery

For contracts calling for delivery of the underlying product, considerations should include deliverable supplies and locations, quality or grade of the deliverable commodity, inspection and certification procedures, size of the delivery unit, adequacy (including accessibility and financial condition) of delivery points and facilities, and the delivery process (timing, storage, shipping).

If there are comparable existing derivative products in other markets and/or if the cash market is in more than one jurisdiction, consideration should be given to the availability of information from the related market authority.¹¹

In order to facilitate commercial use of the market for hedging or pricing, consideration should be given to providing for alternate settlement mechanisms, such as properly structured and monitored exchange-for-physical transactions that permit settlement to be effected or delivery to be made with a different grade or quality or at a different location.

¹¹ See *Guidance on Components of Market Surveillance and Information Sharing*.

- **Responsiveness – The views of potential contract users should be taken into account in designing commodity contracts.**

The views of potential contract users should be taken into account in the design of commodity contracts.

For example, potential contract users may have special needs related to the size of the contract, the commodity grade or the conditions of delivery which, if addressed, could enhance the economic utility and commercial viability of a contract.

Markets themselves will have a commercial interest in the economic utility and viability of a contract. The regulatory interest is related to the commercial interest in that each seeks to ensure that the contract will not be readily susceptible to manipulation so as to assure a well-functioning market.

- **Transparency - Information concerning the contract's terms and conditions, as well as other relevant information concerning delivery and pricing, should be readily available to market authorities and to market users.**

Information concerning the operation of the cash market, delivery requirements (acceptable delivery instruments, delivery procedures, delivery points, etc.), pricing in the cash and futures markets and the terms and conditions of the commodity contract and related rules and procedures of the market (e.g., the minimum tick, price limits and other aspects of the contract such as speculative limits) should be readily available to market authorities and to users.

Recommendation

Each market authority should examine its current practices for the design and/or review of commodity contracts to determine the extent to which its current practices take into account the standards of best practice as set forth in this guidance.

Annex B: Guidance on Components of Market Surveillance and Information Sharing

Introduction

In November 1996 the regulatory authorities and representatives from seventeen countries, responsible for the regulation of many of the world's leading commodity futures markets, met in London to discuss proposals to develop and to strengthen arrangements and practices for the supervision of these markets. They published the outcome of their discussions in a communiqué (the "London Communiqué"), which set out their proposals for strengthening the oversight of commodity futures markets internationally.

With respect to market surveillance, the London Communiqué agreed to promote the adoption of effective market oversight measures in order to detect abusive conduct and to ensure the operation of fair and orderly markets. The London Communiqué also called for improvements to information sharing arrangements, particularly in the identification of large exposures.

During the early part of 1997 a survey of market surveillance practices and information sharing arrangements was undertaken across the seventeen countries that had issued the London Communiqué. The results of the survey were published in June 1997 and discussed by regulators attending the London International Derivatives Week Conference¹. Simultaneously, the report of the Subcommittee on the London Communiqué of the

¹ Results of *Surveys on Contract Design, Market Surveillance and Information Sharing* (June 1997)

Consultative Committee of the International Organisation of Securities Commissions (“IOSCO”) on surveillance of commodity futures markets was published and considered².

The parties to the London Communiqué agreed to set up a working party³ to develop formal guidance on components of market surveillance and information sharing in commodity futures markets⁴. This paper sets out that guidance as a statement of best practice. The main thrust of the guidance is focused on exchange markets. It also covers the treatment of large exposures on these or related markets.⁵

Regulators discussed the draft guidance at the Bürgenstock Conference in September. Following further consultation and discussions, final guidance was published at the Tokyo Commodity Futures Market Regulators’ meeting in October 1997.

Statement of Intent

- i) This guidance seeks to set forth the fundamental precepts for regulating and conducting surveillance of markets that are common to market authorities. However as it recognises differences in the powers of market authorities⁶ and the regulatory powers of each jurisdiction, this guidance does not seek to prescribe the formal arrangements for undertaking market surveillance or for sharing information. Each jurisdiction should determine the type of oversight and components of surveillance, whether statutory or contractual or a combination of these, which is adopted for operating and regulating markets, including conducting market surveillance and sharing information with other regulators whether domestic or outside the jurisdiction.

2 The Subcommittee was formed to offer assistance from futures exchanges and other futures industry self-regulatory organisations to governmental regulators participating in the London Communiqué work programme. The Subcommittee published its *Response to the Survey of Opinion Regarding Best Practices for Terms and Conditions of Commodity Contracts and Surveillance of Commodity Markets and Over-the-Counter (OTC) Commodity Futures Activity (“Market Surveillance”)* on 30 May 1997

3 The working party was chaired by the Financial Services Authority, formerly The Securities and Investments Board (UK) and the Ministry of International Trade and Industry (Japan), in conjunction with the Ministry of Agriculture, Forestry and Fisheries (Japan). It comprised certain participants from the London Conference.

4 This guidance addresses the supervision of exchange markets and, as applicable, OTC markets which are directly related to the relevant exchange market. It does not offer guidance on the surveillance of OTC market activities which are unrelated to contracts dealt on an exchange. For the purposes of this guidance, references to “commodity futures markets” or “markets” are to on-exchange and related OTC markets as the context requires. Where necessary, on-exchange and OTC markets are differentiated in the text.

5 For the purposes of this guidance, the term “commodity contract” refers to futures contracts, options on futures contracts and options for which the underlying reference interest is a physical commodity. Although much of this guidance could also be applied to contracts where the underlying interest is a financial instrument, the guidance is intended to apply to physical-based commodity contracts or other non-financial deliverables with finite supply. In addition, the guidance is intended to apply to exchange-traded derivatives products and is not directed to OTC products except as expressly indicated.

6 In the context of this guidance, “market authority” means the regulator of the market, whether on-exchange or OTC, and could be a government body, self-regulatory organisation or an exchange or several of these. “Government body” could include a public prosecutor or the courts.

- ii) It is also important to bear in mind that market surveillance is only one mechanism used to ensure market integrity. This guidance - which also incorporates guidance on information sharing essential to such surveillance - should not therefore be treated in isolation, but considered in conjunction with the guidance issued on contract design⁷, guidance on information sharing between markets⁸ and other relevant guidance⁹.

Summary of Best Practice Guidance

This guidance covers the following areas:-

- **Framework for undertaking market surveillance:** each commodity futures market and other market authorities should have a clear framework for conducting market surveillance, compliance and enforcement activities and there should be oversight of these activities.
- **Access to and collection of information:** information should be collected on a routine and non-routine basis for on-exchange and related cash¹⁰ and over-the-counter (“OTC”) markets and should be designed to assess whether the market is functioning properly. Market authorities should have access to information that permits them to identify concentrations of positions and the composition of the market. It is acknowledged that data on related cash and OTC markets may be less immediately accessible than data for exchange markets. This may be an area which requires governmental powers.
- **Analysis of information:** analysis of information should be suitable for the type of information collected and both collection and analysis of information should occur speedily.
- **Analysis of market abuse:** adequate powers and capacity should be maintained to investigate actual or suspected market abuse and there should be clarity as to what constitutes abuse.

7 See *Guidance on Standards of Best Practice for the Design and/or Review of Commodity Contracts*.

8 See the proposed IOSCO publication *Guidance on Information Sharing* (pending November 1997).

9 See, for example: *Clearing Arrangements for Exchange-Traded Derivatives*, Bank for International Settlements (December 1996).

10 For the purposes of this guidance, the term ‘cash market’ refers to the market for trading the product underlying the commodity contract.

- **Intervention powers in the market:** effective powers should be available to intervene in the market to prevent or to address abusive practices or disorderly conditions and there should be clarity as to the types of intervention which could occur.
- **Disciplinary sanctions against members of the market:** effective powers should be available to discipline market members and there should be clarity as to the types of possible disciplinary action.
- **Non-members of the market:** the relevant authority should have power to address the abusive actions of non-members of the market.
- **Information sharing:** market authorities should co-operate to share information, in particular information on large exposures. Information should be handled confidentially. Information obtained should be used solely for carrying out the supervisory responsibilities of the relevant authority and as specified in the request for information.

Framework for Undertaking Market Surveillance

1. Each commodity futures market should have a clear framework for conducting market surveillance, compliance and enforcement activities. It is essential that the framework facilitates the hands-on supervision of markets, including enforcement action. The framework should also ensure oversight of the surveillance, compliance and enforcement functions of the market.
2. Effective arrangements should be in place to permit on-exchange and related cash and OTC activities to be analysed, when needed, on a combined basis. In particular, such arrangements should be designed to offer a prompt and comprehensive overview of a market member's or user's overall position and activities in relation to the market and to related markets.

Access to and Collection of Information

3. In physical delivery markets with finite supply, information is a critical tool for maintaining fair and orderly markets and ensuring market integrity¹¹. Accordingly, market authorities should have access to information that permits them to detect and to deter abusive practices and disorderly conditions in the markets, including access to information that permits them to identify concentrations of positions and the overall composition of the market. Price volatility of itself does not necessarily constitute a disorderly

¹¹ For further information on the types of information useful to manage price readjustment or volatility in a particular contract, see the proposed IOSCO report *Guidance on Information Sharing* (pending November 1997).

market. Some of this information may have to be collected from market participants, who should be obliged to provide the information on a timely basis¹². Where information is collected by different regulators or authorities within the same jurisdiction (for instance, in respect of on-exchange and OTC markets) effective cooperation should exist for the exchange of information between the regulators and authorities, so that they can perform their respective functions. Where necessary, specific arrangements for the exchange of information should be made. Such arrangements should, so far as possible, seek to ensure that information is obtained from the market authority that originates or can most easily provide the information. It is acknowledged that data on related cash and OTC markets may be less immediately accessible than data for exchange markets. This may be an area which requires governmental powers.

4. In respect of on-exchange transactions, a market authority should collect information on a routine and regular basis on:
 - i) pricing of contracts throughout the trading day in real time;
 - ii) transactional information including date of trade, commodity contract, delivery month, expiry date, buy/sell, quantity, counterparties to the contract, and price of the contract;
 - iii) positions held by market members (both “whole firm” and individual trader) and market users where the size of the position is above a specified level. Information collected should identify each position holder (by name or code) down to first customer level, and the size of position, by contract month, for each position holder. The market authority should have the capability to aggregate position holder information promptly;
 - iv) warehouse stocks or other deliverable supply.
5. In respect of related OTC transactions, a market authority should consider what information it should collect on a routine basis and what it should collect on an ‘as needed’ basis. This information could include:
 - i) transactional information including date of transaction, commodity interest, duration and maturity of contract, buy/sell, quantity, counterparties to the contract and price of contract;
 - ii) position information;
 - iii) delivery intentions.

12 In the context of this paragraph, “market participant” refers to authorised firms and members of regulated exchange markets.

For contracts other than forwards, additional information may also need to be sought on notional values, replacement cost, valuation methodology or duration of the contracts.

6. Market authorities should, for on-exchange and related OTC transactions, have authority to collect non-routine information including information from authorised firms as to users of the markets. In order to have information which would be of relevance to running an orderly market, positions held by affiliates, for customers as well as for proprietary accounts may need to be disclosed. Information may also be sought about the existence, size and nature of a related cash or OTC position (including for example whether part of a hedge,¹³ arbitrage or other risk management strategy), about the granting of credit to and utilisation of credit by customers and about delivery intentions. For omnibus accounts, information as to the underlying holders may be needed.

Analysis of Information

7. Market authorities should employ methods for analysing the information which they collect which are efficient and suitable to the type of information collected. For instance, information technology and analytical systems should be employed where there is a large volume of information to be analysed. Consideration should also be given, where possible, to requiring information to be provided on-line and in standard form by market members. Standardisation of data collection across markets would, in due course, foster improved cross-border surveillance of linked international markets.
8. Speed is essential in respect of collecting and analysing information for market surveillance purposes. Market members should be required to maintain and to retain relevant records in a readily available form.

Analysis of Market Abuse

9. Market authorities should retain adequate enforcement powers and capacity to deal with abusive practices on their markets and should distinguish between those which apply to on-exchange activity and those which apply to OTC activity, as appropriate. Such powers should include:

¹³ For the purposes of this guidance, the term “hedge” or “hedging” refers to the taking of a position in a commodity contract opposite to a position held in the cash or OTC market to minimise the risk of financial and/or economic loss from an adverse price change, or otherwise for risk management purposes. Conduct that is described as permissible hedging activity may differ among jurisdictions.

- i) investigative powers to obtain documents (including proprietary systems and software) and to question persons involved in suspected market abuse. These powers may be shared between authorities (where, for instance, an exchange has investigative powers against its members and wider investigative powers are remitted to a government body, including a public prosecutor or the courts);
 - ii) the power to intervene in the market;
 - iii) the power to take disciplinary action against members;
 - iv) the power to initiate or to refer appropriate matters for criminal prosecution.
10. Market authorities should have rules and compliance programmes to prevent or to deter abusive practices on their markets, including manipulation or attempted manipulation of the market. There should be clarity as to what constitute manipulative activities or abusive actions. The rules and compliance programmes should take account of the whole position of the market participant.
11. Specific manipulative or abusive practices which market authorities should seek to prevent include, among others:
- i) intentionally causing, or attempting to cause, artificial pricing in the market;
 - ii) creating a false or misleading appearance of active trading;
 - iii) intentionally disseminating false or misleading information in respect of the market;
 - iv) creating a corner or squeeze, in which an abusive controlling position is accumulated in the physical and/or futures markets, forcing those holding short positions to settle their obligations, by purchase or offset or otherwise, to their detriment;
 - v) abuse of customer orders;
 - vi) “wash trades”, involving no change of beneficial ownership;
 - vii) collusive trades, which seek improperly to avoid exposure to the pricing mechanism of the market;
 - viii) violation of applicable position limits;
 - ix) concealment of a position holder’s identity.

Intervention Powers in the Market

12. Market authorities should have, and use, effective powers to intervene in the markets to prevent or to address market abuse or a disorderly market. There should be clarity as to the types of intervention which could occur. Use of such powers may be appropriate after informal efforts to encourage orderly behaviour by market participants have failed.
13. Market authorities could, among other things, employ some or all of the following measures, as appropriate to address the perceived market threat:
 - i) the imposition of position limits, in particular in the delivery month;
 - ii) the imposition of price limits;
 - iii) calling for additional margin, either from customers or from clearing members;
 - iv) ordering the liquidation or transfer of open positions;
 - v) suspending or curtailing trading on the market;
 - vi) altering the delivery terms or conditions.
14. Market authorities should retain emergency powers to maintain an orderly market in exceptional circumstances and should use those powers judiciously.

Disciplinary Sanctions against Members of the Market

15. Market authorities should have and use effective powers to discipline their members if an abusive practice has occurred in the market. There should be clarity as to the types of disciplinary actions which can be taken.
16. Sanctions should, amongst other things, include some or all of the following measures:
 - i) warnings;
 - ii) reprimands;
 - iii) requiring re-training to be undertaken;
 - iv) requiring restitution to be made;
 - v) fines;
 - vi) imposing conditions on trading;

- vii) trading prohibitions;
- viii) suspension from membership;
- ix) expulsion from membership;
- x) where appropriate, a criminal referral.

Non-Members of the Market

17. The relevant authority should have power to take action against non-members of exchange markets if they have engaged in abusive or manipulative practices, or are suspected of doing so. It is anticipated that these powers will usually be embedded in statute and would be exercised by a government body, including a public prosecutor or the courts.
18. In addition, market authorities should be able to intervene in the market to address or to prevent an abuse by non-members, using appropriate measures – through members – such as raising the level of margin, imposing trading limits and liquidating positions. Intervention action should be timely.

Information Sharing

19. Market authorities should cooperate with one another, both domestically and outside the jurisdiction, to share information for surveillance and disciplinary purposes. In particular market authorities should be able to share information on large exposures in linked markets and on supplies relative to these markets. These arrangements should take account of guidance issued in respect of information sharing¹⁴ and of existing Memoranda of Understanding, in particular the agreements executed at Boca Raton in March 1996.
20. Market authorities should keep confidential requests for information and details of information exchanged. Market authorities should use no less care in handling information received from another regulator than they would employ to protect the confidentiality of equivalent domestic information. The passing of non-public information by a requesting market authority to another market authority may be conditioned on the requested authority being satisfied as to the obligation of each such authority to maintain an equivalent level of confidentiality.

¹⁴ See, for example, IOSCO publications: *Principles for Memoranda of Understanding* (September 1991), *Mechanisms to Enhance Open and Timely Communication Between Market Authorities of Related Cash and Derivative Markets During Periods of Market Disruption* (October 1993) and *Report on Cooperation Between Market Authorities and Default Procedures* (March 1996)

21. Information shared between market authorities should be used solely for carrying out the supervisory responsibilities of the requesting market authority. A request for information should indicate precisely the reason for the request. Such information should not be used contrary to conditions relating to the use of that information by the requested market authority to give effect to laws, rules or regulations in force in the requested authority's jurisdiction.
22. Market authorities should, in principle, be prepared to share the following types of information with other market authorities on a routine basis, as requested:
- i) specification details of each commodity contract;
 - ii) details of market regulations such as position limits and price limits;
 - iii) details of delivery rules and procedures;
 - iv) general details about the range of market information collected and analysed;
 - v) details of designated warehouses;
 - vi) contact names in respect of each market.
23. When a specified concern exists about a potential abuse of a market, market authorities should be prepared to provide the following additional information, as appropriate, to market authorities in related markets, whether domestic or outside the jurisdiction, promptly and comprehensively:
- i) details of members' positions;
 - ii) details of large positions held by members and users of the market. Information should be made available in respect of on-exchange, related OTC and cash positions;
 - iii) inventory levels and locations of delivery stocks;
 - iv) changes to position limits;
 - v) additional margin calls.

Recommendation

It is recommended that each market authority should review their market surveillance and information sharing arrangements and seek to ensure that this guidance is put into effect. Market authorities should also seek to participate in and make use of the arrangements for sharing information which are set out in the Boca Raton Declaration.

London Communiqué on Supervision of Commodity Futures Markets

REPRESENTATIVES OF REGULATORY AUTHORITIES FROM SEVENTEEN COUNTRIES RESPONSIBLE FOR SUPERVISING COMMODITY FUTURES MARKETS (COLLECTIVELY “THE AUTHORITIES”) MET ON NOVEMBER 25 AND 26 IN LONDON IN THE UNITED KINGDOM TO ADDRESS THE OVERSIGHT OF COMMODITY FUTURES MARKETS AND ISSUED THE FOLLOWING:

LONDON COMMUNIQUÉ ON SUPERVISION OF COMMODITY FUTURES MARKETS

THE AUTHORITIES RECOGNISED THAT:

- there have been significant developments affecting international commodity markets, such as the liberalisation of trade policies and capital flows, an increase in privatisation initiatives, and the diminution of price supports;
- these developments have implications which include the creation of new demands for the international use of commodity futures contracts as a means of managing price risk;
- commodity contracts which are based on an underlying commodity, and which settle in cash or by physical delivery, have characteristics different from highly liquid financial futures contracts; this is particularly the case when supply is limited, subject to relatively high production, transportation, storage and delivery costs, subject to seasonal shortages, or subject to long production lead times;

- the potential for market integrity concerns is compounded by the increasingly global nature of commodity pricing, production, storage and delivery facilities and the diverse regulatory treatment of these facilities;
- market authorities¹ must take steps to address the international supervisory implications of the above developments, including their implications for market integrity, market surveillance, supervisory cooperation, international systemic risk, and for confidence in the markets.

THE AUTHORITIES further recognised the substantial progress that has been achieved in other international fora with respect to market supervision and cooperation and the relevance of such developments to this meeting's agenda. The Authorities noted, however, that no forum to date has addressed the particular concerns raised by markets whose underlying product is a physical commodity.

THE AUTHORITIES addressed on a multilateral basis the special concerns raised by commodity futures markets and identified where further work could enhance their ability to supervise the markets subject to their respective jurisdiction, in particular in the following areas:

- Contract specifications
- Market surveillance; and
- Information sharing and cooperation.

I THE AUTHORITIES REACHED THE FOLLOWING POINTS OF CONSENSUS

- That the proper design of commodity contracts
 - not only enhances their economic utility but also is a critical aspect of market integrity in that proper design reduces the susceptibility of such contracts to market abuses, including manipulation;
 - complements but is not a substitute for an appropriate market surveillance programme.

¹ The term "market authorities" for the purposes of this Communiqué includes regulatory entities, markets and/or self-regulatory organisations.

- That an active and effective market surveillance programme by the market regulatory authorities
 - is essential to ensure that commodity futures markets operate in a fair and orderly manner;
 - should be designed to detect, to prevent, to take corrective action with respect to, and to punish abusive conduct and should be supported by appropriate regulatory measures;
 - requires that market authorities have access to necessary information, subject to appropriate confidentiality provisions;
 - should be designed to address cash market conditions.
- That market authorities of related markets should share to the extent permitted by their laws, rules and regulations surveillance information to manage a market disruption and should designate contact persons for such purposes.
- That regulatory measures which facilitate the identification of large exposures should be developed. These measures may involve access to information relating to persons holding or controlling such large exposures and their related derivatives, over-the-counter and cash market positions. These measures may also involve access to information on deliveries.
- That information may be necessary (1) about the normal operation of markets; (2) when strong concerns exist about potential abusive conduct; or (3) when corrective actions or sanctions may be warranted.
- That the information shared should be obtained for the regulatory purposes of the requesting market authority only and should not be used for any other purposes.
- That market authorities will keep confidential the request for information and information exchanged, consistent with the needs including the laws and regulations in force in the jurisdiction of the requested authority and with the domestic laws and regulations in force in the jurisdiction of the requesting authority. In no event will they use a degree of care less than that employed to protect the confidentiality of equivalent domestic information.

II THE AUTHORITIES AGREED TO PROMOTE

With respect to contract design:

- The consideration of appropriate contract design principles by relevant market authorities to ensure that the terms and conditions of commodity contracts, including cash settlement terms, if applicable, minimise the susceptibility of such contracts to abusive conduct.
- Clarity as to criteria and procedures for review and/or approval of contract design.

With respect to market surveillance:

- The adoption of effective market oversight measures which permit the monitoring of compliance with relevant laws, rules and procedures and the implementation of such measures to detect abusive conduct and to ensure a fair and orderly market.
- The development of regulatory measures which facilitate the identification of large exposures for surveillance purposes.
- Clarity as to (1) the types of activities which can impair the orderly operation of commodity markets, (2) measures for detecting and preventing abusive conduct, and (3) the types of intervention and sanctions authorised under relevant laws, rules and procedures.
- The adoption of rules and procedures that authorise a market authority to intervene in a market situation and, if necessary, to punish abusive conduct.
- Greater availability of information on prices, open interest and deliveries.

With respect to information:

- Greater cooperation among market authorities in the sharing of relevant information concerning the supervision of their respective markets, both on a routine basis and as needed, and to promote communication among relevant personnel.
- Clarity of procedures for access to information by market authorities.

III THE AUTHORITIES RECOMMENDED THAT FURTHER WORK SHOULD BE UNDERTAKEN TO CONSIDER

With respect to enhancing clarity of existing practices and procedures:

- A survey of the status and types of existing and planned commodity futures markets and of the practices and procedures concerning the review by market authorities of contract terms and conditions.
- A survey of (1) existing practices and procedures with respect to market surveillance, (2) who is responsible for specific surveillance functions, (3) the types of surveillance information which market authorities may obtain, including end-user information, and (4) who has the authority to collect and to use such information.
- A survey of existing regulatory powers to adopt measures designed to prevent or to inhibit abusive conduct and a survey of the prohibitions of such conduct.

With respect to contract design:

- The development of standards of best practices for the design and/or review of commodity contracts.

With respect to market surveillance:

- The development of guidance on techniques for market surveillance intended to detect and to prevent abusive conduct.
- The development of procedures to identify large exposures, including, where practicable, means to obtain information on the related derivatives, over-the-counter and cash market positions of traders.

With respect to information sharing:

- An examination of existing arrangements, such as the Declaration on Cooperation and Supervision of International Futures Exchanges and Clearing Organisation, to assess the extent to which such arrangements facilitate the sharing of information for purposes of detecting and preventing abusive practices and other disruptions on commodity markets. In conducting this examination, particular reference should be made to the considerable work accomplished by the International Organisation of Securities Commissions in developing principles and methodologies for information sharing among market authorities.

- The support of efforts to categorise and to prioritise the information which market authorities may wish to share during specific market events, such as the possibility of market manipulations, and otherwise to facilitate international information sharing.
- The support of efforts to provide certain up-to-date public information about the contracts, rules and procedures of commodity markets through a vehicle such as the Internet.
- The prompt designation by each market authority of a contract person to communicate necessary surveillance information.

Work Programme

It was agreed that the work will be undertaken immediately by two working parties drawn from the participants in the meeting. The first working party will address issues arising from contract design. The second will address concerns relating to market surveillance and information sharing. The working parties will consult interested parties as necessary. It is the intention that the work will be completed within 12 months and a further meeting will be convened in Japan at that time.

Participants at Conference

Australian Securities Commission *Australia*

Comissão de Valores Mobiliários *Brazil*

Canadian Grain Commission *Canada*

Commission des Opérations de Bourse *France*

Bundesaufsichtsamt für den Wertpapierhandel *Germany*

Securities and Futures Commission *Hong Kong*

Hungarian Banking and Capital Market Supervision *Hungary*

Commissione Nazionale per le Società e la Borsa *Italy*

Ministry of International Trade and Industry *Japan*

Ministry of Agriculture, Forestry and Fisheries *Japan*

Ministry of Finance and Economy *Korea*

Securities Commission *Malaysia*

Securities Board of the Netherlands *The Netherlands*

Singapore Trade Development Board *Singapore*

Financial Services Board *South Africa*

Financial Services Authority *United Kingdom*

Commodity Futures Trading Commission *United States of America*