



RESEARCH ON

Regulating Agricultural Derivatives Markets



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After years of **financial deregulation**, the agricultural commodity price shocks of 2007/2008 and 2010/2011 acted as a catalyst for governments to **strengthen the regulation of derivatives markets**.

It is increasingly recognised, at national and international levels, that **financial players influence the volatility of commodity prices** on exchanges and in spot markets. Reforms of the legal framework of futures markets are being carried out to:

- Provide additional transparency requirements in agriculture derivatives market.
- Guarantee broad market information on the physical (spot) markets.
- Impose position limits on several agricultural commodities.
- Reinforce regulators' powers.

Agricultural volatility in the global era

The **systemic instability of agricultural markets** has always been a key factor in agricultural policies. The biological nature of agricultural production processes and their strong dependency on natural and climatic conditions induce a higher degree of uncertainty surrounding the economic performance of farm enterprises, in comparison to what happens in other sectors of the economy. Thus, stochastic factors exert significant influence on both agricultural productivity and supply.

Over the period 2002–2013, international agricultural prices doubled **and historical peaks were reached in mid-2008 and, in particular, in February 2011**, when the [FAO Food Price Index](#) recorded 238 points compared to the 2002-2004 baseline (i.e. almost two and a half times higher). It averaged 205.8 points in October 2013, 2.7 points (1.3 per cent) above September, but still 11 points (5.3 per cent) below its October 2012 value. Last month's increase was the first recorded since April 2013. It was largely driven by a surge in sugar prices, although prices of the other commodity groups were also up.

After **thirty years of real terms decreases in food prices** in Europe and worldwide, the recent volatility phenomena has generated a debate about the impacts on the agricultural sector arising from both the frequency and magnitude of price changes. Economic literature supports the hypothesis of **greater uncertainty and increased volatility in agricultural markets in the near future** ⁽¹⁾. Otherwise, there is a widespread belief that the excessive

¹ Uncertainty and volatility in spite of the European Commission's estimates that the agricultural prices of the coming decade could be between 10 and 30% higher than those recorded between 1990 and 2000 (see [EC, 2012](#)). Concerning the future evolution of agricultural markets, see also: [OECD-FAO \(2013\)](#), [FAO \(2013\)](#) and [McKinsey & Company, 2013](#).

volatility benefits neither producer nor consumer, blurring market signals for producers and potentially threatening the most vulnerable consumers.

A broad consensus across the analyses performed points to the **volatility phenomenon** in the current global era being explained by multiple **elements affecting both supply and demand**. While **short-term volatility** is influenced by many factors, such as droughts, floods, variable temperatures, and policy responses (e.g. governments in major agricultural regions banning exports), there also appears to be increasing evidence of a more structural supply issue that is driving **long-term volatility** ([McKinsey & Company](#), 2013: pages 1-2). Such factors not only increase the risk of disruptions to supply but also make supply even more inelastic. As supply becomes increasingly unresponsive to demand, even small changes in that demand can result in significant changes of prices.

The **prices of different commodities** have been increasingly **closely correlated** over the past three decades. Rapid growth in demand for resources (energy, metals, agricultural products) from China and other emerging economies has been an important driver of these increased links. But the consolidation of a resource/commodities global system as well as the reinforcement of interdependence between the prices of agricultural products and energy prices, become also important. Higher energy prices affect food markets increasing the price of inputs and the costs of processing and transport. In addition, the emergence of *biofuels' first generation* as novelty commercial outlets for agricultural products is distorting food demand. As a result, shocks in one of the commodities system (e.g. energy) today can spread rapidly to other parts of the resource system (agriculture).

In this context, **financial speculation in commodity derivatives** markets has been seen as **one of the drivers** of the peaks in agricultural prices in 2007/2008 and 2010/11. The [ULYSSES project](#) (2013a) for example, which focused on the analysis of the true causes of the spikes in commodity prices, screened 72 papers in order to identify which drivers have received most attention. Studies investigating the impact of financialisation and speculation were the clear winners in the existing literature (34 in total).

Agricultural commodities in the derivatives exchanges

There are approximately **twenty major derivatives exchanges** around the world that trade **different agricultural commodities**. The two major US markets are: the **Chicago Board of Trade** (CBOT) for the standard reference prices of soybeans, corn and soft wheat; and the **Kansas City Board of Trade** (KCBT), for hard wheat. Now both markets are part of the [Chicago Mercantile Exchange Group \(CME\)](#).

In the European Union, the main markets are **Euronext Paris** and **London International Financial Futures and Options Exchange** (LIFFE) (both are part of the [NYSE Euronext Group](#)). Paris is today the most important exchange for rapeseed. Complementarily, it has become increasingly important as a pricing basis market for wheat related to Russian and Ukrainian deliveries.

The most relevant markets in Asia are: the Kansai Commodities Exchange ([Osaka Dojima Commodity Exchange](#)) (rice) and the [Tokyo Commodity Exchange](#) (soybeans, corn, azuki beans, raw sugar) in Japan; the [National Commodity & Derivatives Exchange Limited](#) in India; the [Dalian Commodity Exchange](#) and the [Zhengzhou Commodity Exchange](#) in China; the [Agricultural Futures Exchange of Thailand](#) (AFET) (white rice); and the [Singapore Exchange](#) (SGX - ex JADE) (crude palm oil).

Other significant exchange markets for some agricultural commodities are: the [ICE Futures Canada](#); the [Australian Securities Exchange \(ASX\)](#) (mainly wheat); the [South African Futures Exchange](#) (SAFEX) - Johannesburg Stock Exchange (JSE) (relevant for white maize futures price); and the [Brazilian Mercantile and Futures Exchange Bovespa](#).

Exchange traded derivatives are always **regulated by national supervisors** protecting participants against manipulation, abusive trade practices and fraud: the [Commodities Futures Trade Commission \(CFTC\)](#) in the US; the *Financial Services Authority* (FSA) in UK;



the *Banque de France* and the *Autorité des Marchés Financiers* (AMF) in France; the *China Securities Regulatory Commission* (CSRC); the *Forward Markets Commission* (FMC) in India; the *Financial Services Agency* in Japan; the *Australian Securities and Investments Commission* (ASIC) and the *Reserve Bank* in Australia; or the *Financial Services Board* (FSB) in Brazil.

However, **rule exemptions are usual**, including commodity index funds. Furthermore, private contracts traded off-exchange, the **"Over-The-Counter" (OTC) transactions**, are increasingly relevant among the commodity derivatives instruments. Today around 85% of the derivatives trading are OTC. By the end of 2012, the size of the OTC commodity derivatives markets (agricultural and non-agricultural) stood at \$2.6 trillion in national value, according to the Basel-based Bank for International Settlements. Paradoxically, despite their bilateral nature, without going through an exchange or other intermediary, OTC are free of any disclosure requirements with regard to prices, trading parties, time or underlying assets.

There is no doubt that investments in agricultural commodity markets have grown at an astonishing rate in recent years, but conflicting opinions enliven the debate on the impact arising from this phenomenon.

Price volatility vs. "financialisation" of agricultural derivatives: the academic perspective

The sharp increase in financial investments in agriculture derivatives markets over the last decade as well as the high levels and extreme volatility of agricultural prices experienced after 2007/2008 highlighted the need to devote **greater analytical attention to price formation in commodity markets**, including interaction between spot and futures price volatility as well as the impact of "*financialisation*" of commodities (see [Valiante, 2013](#)). However, academic research appeared to reach different conclusions.

Some surveys on economic literature on the causes of food market volatility find that there is **little evidence at a scientific level** that the large inflow of speculative capital in futures and options markets impact spot prices in the mid to long term ([Meijerink et al., 2011](#): Chapter 5, pages 54 to 72; [Shutes & Meijerink, 2012](#); [ULYSSES Project, 2013b](#): pages 22 & 35). Speculators would simply respond to the more fundamental changes in supply and demand conditions in commodity global markets. They would also provide greater liquidity to the markets in ways that increased their efficiency. Reinforcing these points, there is a tendency to find price volatility reducing impacts of index fund trading for major cereals in particular. Some economists also note that the prices of some commodities not traded in futures - or not included in commodities indices - have also risen sharply. For these researchers, increased speculation could have led to more volatility in the short term, which is not to affect farmers or consumers.

Other analysts do not share the same view of the consequences of derivatives markets on agricultural prices. They argue that "*excessive speculation*" drives price volatility and remark that often bilateral relationships exist between price volatility and speculation, even if the linkages are not always overlapping for all the considered commodities (for example, rice or soybeans) ([Algieri, 2012](#); [Cordier & Gohin, 2012](#); [Lagi et al., 2012](#)) ⁽²⁾. For these researchers the financial deregulatory moves implemented in 1980s and 1990s increased the scale of cash flows in commodity futures by institutional investors (pension funds and other long-term investors) through index-based swap transactions as a portfolio diversification strategy ([Baffes & Haniotis, 2010](#)). The trading strategies of financial of these new "*price-*

² See also [Henn, M. \(2013\)](#) for a compilation of references on the negative impact of commodity speculation by academics, analysts and public institutions.

insensitive" investors are largely not based on fundamental demand and supply conditions. The often dominant role of financial investors in physical commodities increases the likelihood of excessive short term price fluctuations distorting the price formation process in short term ([OFSE, 2013](#)): futures prices in agricultural products would increasingly diverge from the cash market price and would fail to converge at the time of contract expiration. Furthermore, the long positions of the new investors are predominantly held to hedge **OTC transactions**. The main problem with such derivatives is that they decrease transparency and can also create a great amount of risk and uncertainty.

In this context, more and more academics are in favour of **improving regulation of commodity markets** ([Clapp and Helleiner, 2012](#); [Lecocq and Courleux, 2011](#); [OFSE, 2013](#)). **NGOs** support strongly the criticisms about the role of derivatives instruments in agriculture and they are strongly pushing for tighter regulation (see for example: [SOMO, 2010](#); [SOMO, 2012a](#); [World Development Movement, 2012](#); [Friends of the Earth Europe, 2012](#); [SOMO, 2013](#); [OXFAM, 2013](#); [CNCD, 2013](#)).

In fact, the current **absence of academic consensus** on the impact of financialisation and speculation on food price volatility is likely affected by the lack of data, by the heterogeneity of concepts employed, and by the lack of regulatory measures ([ULYSSES, 2013a](#): page 6; [SOMO, 2012a](#): page 4).

Anyway, it is **increasingly recognised** at national and international levels (**G20, UNCTAD, FAO**) that financial players influence the volatility of commodity prices on exchanges and in spot markets ⁽³⁾. Following the guidelines of G20 in particular, reforms of the framework for futures markets are being made among the public bodies to:

- provide additional transparency requirements in financial markets;
- guarantee broad market information on the physical markets;
- impose **position limits** on several agricultural commodities; and reinforce regulators' powers.

Building new frameworks for the derivatives markets

The first institutional initiatives improving regulation of commodity derivatives markets: the G20 developments

It follows from above that, in the future, **price and supply crises are likely to be more frequent** and, perhaps, more severe. This would have a negative impact on the incomes of producers, on the food chain as a whole and, of course, on food availability, particularly for the poorest population groups.

It is increasingly a mission of the public institutions to assure the functioning and strength of markets (both physical and futures markets). In this context, the issue of food security became **one of the priorities of the G20 agenda** which evaluated measures to mitigate and manage more effectively the risks associated with price volatility in agricultural commodities ([Capitanio, 2013](#); [Clapp and Murphy, 2013](#)).

The *International Organization of Securities Commissions* (IOSCO), created in 1983 in order to facilitate cooperation among securities regulators, set up a *Special Task Force on Commodity Futures Markets* in September 2008, following political, academic and media

³ Olivier De Shutter, Special Rapporteur on the Right of Food, is calling for greater regulation of commodity markets (see, [UN, 2010](#)). [UNCTAD](#) is also requiring swift political action on a global scale in order to restore the proper functioning of commodity markets (see, [UNCTAD, 2012](#), [2013a](#) and [2013b](#)). Relating to UNCTAD's analysis on the links between financial and commodity markets, see: [Bicchetti and Maystre \(2012\)](#); [Mayer \(2012\)](#); and [Mayer \(2009\)](#).

debate concerning the behaviour of commodity markets in a period which has seen considerable price rises in certain agricultural products and increased market volatility. The **special IOSCO Task Force** presented its final report in March 2009 which highlighted the need for greater transparency of commodity derivatives markets, particularly **OTC** activity (the largest derivative market which is not subject to margin collateral, data reporting and other requirements of regulated exchanges). The report urged national regulators to review their powers to ensure that they could gather information on OTC markets (as well as transactions in physical markets and stock levels) ([IOSCO, 2009](#)).

Following these recommendations, at the Pittsburgh Summit in September 2009, the G20 already required that all standardised **OTC derivative contracts** be traded on exchanges or electronic trading platforms and cleared through central counterparties (**CCPs**) by the end of 2012.

The G20 Agriculture Ministers issued an *Action Plan on Food Price Volatility and Agriculture* at their 22–23 June 2011 meeting, in Paris ([G20, 2011a](#)). This document stressed the need for: 1) *improving agricultural production and productivity*; 2) *increasing market information and transparency*; 3) *strengthening international policy coordination*; 4) *improving and developing risk management tools*; and 5) **improving the functioning of agricultural commodities markets** (Page 3 of Ministerial Declaration, Paragraph 11).

In addition, the G20 Agriculture Ministers welcomed the work of the IOSCO based on the set of concrete measures to ensure a better functioning and more transparent agricultural financial markets (including OTC derivatives) to prevent and to address market abuses, cross-market manipulations and disorderly markets (Page 13 of Ministerial Declaration, Paragraph 54). On this basis, the G20 Agriculture Ministers strongly encouraged G20 Finance Ministers and Central Bank Governors to *take the appropriate decisions for a better regulation and supervision of agricultural financial markets* (Page 14 of Ministerial Declaration, Paragraph 55).

The Action Plan was endorsed by the G20 leaders in November 2013, in the Cannes Summit. In fact, the final G20 communiqué of Cannes ([G20, 2011b](#)) reinforced the Agricultural Ministers' Plan endorsing directly the IOSCO recommendations to improve regulation and supervision of commodity derivatives markets. Of all the recommendations the one on the scope of intervention was the strongest: "*market regulators should be granted effective intervention powers to prevent market abuses. In particular, market regulators should have and use formal position management powers, among others powers of intervention, including the power to set ex-ante position limits, as appropriate*" (Page 3, paragraph 18).

The *Financial Stability Board* (FSB), whose mission is to coordinate and monitor at international level the work of national financial authorities and international standard setting bodies in the interest of financial stability, created the *OTC Derivatives Working Group* (ODWG) in April 2010. This group is playing a key role in transposing the G20's agreed objectives into domestic regulations, in particular relating to **central counterparties** and **trade repositories**. The FSB's Working Group has published six progress reports on implementation of OTC Derivatives Market reforms, in April 2011, October 2011, June 2012, October 2012, April 2013 and September 2013 ([FSB, 2013](#)).

Even if the G20 still appears divided on whether commodity markets need stronger regulation, some **G20 members have progressively implemented measures** aimed at improving the regulation standards and functioning of agricultural derivatives markets in order to increase pricing transparency and to reduce bilateral or counterparty credit risk (US in 2010, Japan in 2011, EU in 2012 and Canada in 2013). Despite Singapore and Switzerland not being members of the G20, they also attempted to tighten regulation. Although these efforts could be described as uneven and not particularly coordinated ([Clapp and Murphy, 2013](#); [Vander Stichele, 2011](#)), the progress on this front is undeniable ([Jackson and Miller, 2013](#)).

The recent push for tighter regulation in the US and EU

After years of financial deregulation, the agricultural commodity price shocks of 2007/08, followed by another round of high food prices in 2010/2011, acted as a catalyst for Governments to strengthen the regulation of derivatives markets, including the OTC markets, and to reinforce international cooperation among national regulators.

US reform resulted in the passage of the Dodd-Frank Bill of 2010. In July 2010, a London cocoa contract by a single prominent hedge fund caused prices to soar and then collapse, thus revealing that the EU did not have a regulatory system with regard to derivative transactions (cited by [Berg, 2013](#): page 67). Soon after, the *EU reform* process began.

The US Commission Futures Trade Commission (CFTC) and the European Securities and Markets Authority (ESMA) have been specifically tasked with implementing legislation mandated by G20 commitments on derivatives.

Regulatory initiatives in US: the Dodd-Frank Bill of 2010

The growth in trading in US agricultural futures during the 1980s and 1990s was a product of the expansion of the criteria for providing exemptions on agricultural commodity positions.

On 21 July 2010, the [Dodd-Frank Wall Street Reform and Consumer Protection Act](#) (Pub. L. 111-203, H.R. 4173, 21 July 2010) changed the regulatory framework in the US for OTC financial derivatives. In [Section VII](#), the law provided, at the federal level, for the establishment of new market regulation on swaps and security-based swaps.

The main [objectives of reform](#) were: to bring public market transparency and the benefits of competition to the **swaps** marketplace; lower the risk of the interconnected financial system by bringing standardised swaps into centralised **clearing**; to ensure that the swap dealers and major swap participants were specifically regulated; to increase transparency to regulators (swap data repositories); to improve pre-trade transparency of swap transactions; to enhance the price discovery process for market participants and the public; and to impose **position limits** on several (28 different) agricultural commodities.

The regulation and supervision of swaps, swaps dealers and major swap participants in the OTC market of derivatives was attributed to the *Commission Futures Trade Commission* (CFTC). The *Securities and Exchange Commission* (SEC) and the *Federal Reserve Board* (FRB) have also regulatory competences.

The Dodd-Frank Act came into force on July 2011, but its [implementation](#) was delayed until late 2012. Furthermore, the Dodd-Frank Act's mandate to the CFTC imposing stricter position limits was rejected in court and remains under threat. Financial lobbies argued that the CFTC failed to determine whether those limits were either "necessary" or "appropriate". The US court ruling on position limits will have substantial effects not just for US regulation but potentially also for the EU. If the ability of the CFTC to impose position limits is constrained by a requirement to prove their need, the EU may feel pressure to weaken its rules as well ([Clapp and Helleiner, 2012](#)).

Regulatory initiatives in the EU

The agricultural policy perspective: consideration of rising price volatility in the CAP

Two approaches have traditionally been applied by public bodies against instability of agricultural prices ([Galtier et al., 2012](#): 37–46). The first one consists of **mitigating the effects of volatility on farmers and consumers**. This approach privileges the use of decoupling aids, safety nets for incomes and risk management tools (insurance schemes, mutual funds and/or futures markets). The second one is based on the **stabilisation of prices**, in particular by means of measures of public intervention (internal price support, aids and refunds, control supply, border tariffs).

In Europe, faced with the volatility of agricultural prices, the CAP has always been characterised by its intensive market regulation. At the core of this system were public prices, guaranteeing farmers a minimum purchase price for their produce from the authorities in the event of a market crisis.

The CAP reform process had already gathered speed by the [2003 reform](#), which outlined a new path to public support in the farm sector and in rural areas, privileging agriculture's contribution to constructing positive social values and reducing the weight of market protection and internal price support. In this context, one of the challenges addressed by the [CAP Health Check](#) in 2009 explicitly foresaw the issue of risk management as a fundamental matter for future public intervention (see Article 68 of [Council Regulation \(EC\) No 73/2009](#)).

As a result of these reforms, the CAP has been progressively more market oriented. In this context, the current [2020 CAP reform](#), keeping this overall approach, commits to a reinforcement of producers' risk management tools. On 18 November 2010, the European Commission published a [Communication on Common Agricultural Policy \(CAP\) towards 2020](#). In the Section on market measures (Section 6.1, page 10), this document listed the well-functioning transmission of market signals as one of the key issues to be pursued. In this context, increasing transparency and a well-functioning **agricultural commodity derivatives markets** should be encouraged.

Following the publication of the Commission's Communication, the [EP Resolution adopted on 8 July 2010](#) called for "*measures to help reduce volatility and provide stable conditions for agricultural business and planning*" (Paragraph 80). The EP took the view that new innovative economic and financial tools should be considered as a way of dealing with extreme market or climate conditions, without disturbing any private schemes that are being developed.

The [CAP legislative package](#) presented by the European Commission in October 2011 included a risk management toolkit as part of the proposals for rural development policy (CAP second pillar) in order to deal more effectively with income uncertainties and market volatility. However, no specific measures related to derivatives markets could be found in the CAP proposals.

Alternatively, in 2012 the European Commission's Directorate General for Agriculture and Rural Development (DG AGRI) set up a consultative "*Expert Group on Agricultural Commodity Derivatives and Spot Markets*" whose tasks would be to provide advice and expertise to the Commission services concerning: the functioning of the agricultural commodity derivatives and spot markets; the implementing of existing EU legislation and policies; and, finally, the [preparation of legislative proposals and policy initiatives](#) in this field.

In the light of the above, the basic issues revolve around which risk management mechanisms would form part of the CAP model as from 2017 (under a possible Mid-Term Review) or 2020 (after the end of the current Multiannual Financial Framework 2014/2020). Futures markets could play a complementary role accompanying the next CAP reform steps.

Anyway, the initiative power for regulation on derivatives markets in general in the EU corresponds to the Commissioner for **Internal Market and Services** (Mr Michel Barnier).

The so-called "**Barnier Package**" is a major development which enables the European Union to deliver the G20 commitments on derivatives/swap markets setting out new rules on three fields, **clearing**, transparency and **trading**. The objectives were

- To reduce risk in financial firms and systems by clearing all standardised **swaps** through **central counterparties**,
- To shed light on this opaque market and report all trades to **trade repositories**,
- Where appropriate, to move standardised swaps to venues to increase market transparency.

The European Market Infrastructure Regulation (EMIR)

The most relevant element of the *Barnier Package* is the **European Market Infrastructure Regulation** (called *EMIR*). It is aimed at outlining a regulatory framework for OTC derivative contracts. The [proposal of regulation](#) was presented by the Commission in September 2010⁽⁴⁾. In February 2012, the European Parliament and the Council reached agreement. The [final text](#) was published in July 2012 and entered into force on 16 August 2012.

The new Regulation ensures that information on all European derivative transactions will be reported to **trade repositories** and be accessible to supervisory authorities, including the **European Securities and Markets Authority** (ESMA), to give policy makers and supervisors a clear overview of what is going on in the markets.

The Regulation also requires standard derivative contracts to be cleared through **Central-Counter-Parties (CCPs)** as well as margins for uncleared trades and establishes stringent organisational, business conduct and prudential requirements for these CCPs. The legislation means financial firms trading OTC commodity derivatives will also have to clear trades, while non-financial firms will only become subject to the clearing requirement if their positions breach an aggregate threshold of €3 billion.

In December 2012, the European Commission adopted **nine regulatory and implementing technical standards** ([DTCC, 2013](#)) to complement the obligations defined under the Regulation on OTC derivatives, Central-Counter-Parties (CCPs) and trade repositories. They were developed by the European Securities and Markets Authority (ESMA) and have been endorsed by the European Commission without modification. These [texts](#) were published on 23 February 2013 and entered into force on 15 March 2013. The adoption of these technical standards finalised requirements for the mandatory clearing and reporting of transactions, in line with the EU's G20 commitments.

In July 2013, the European Commission proposes *two Delegated acts* specifying the fees to be charged to trade repositories by the ESMA (*C(2013) 4363*) and including the central banks and debt management offices of Japan and the United States in the list of exempted entities under EMIR framework (*C(2013) 4289*). These texts would be adopted by the European Parliament and the Council shortly.

The Markets in Financial Instruments Directive (MiFID) and Regulation (MiFIR)

The [Markets in Financial Instruments Directive \(MiFID I\)](#) has existed since 2009. In October 2011, the Commission adopted [proposals](#) amending the current framework on pre-trade and post-trade transparency, position limits and position reporting. The proposals are divided in two:

- a Regulation (COM (2011) 652) (**MiFIR**) amends the current EMIR and sets out requirements in relation to the disclosure of trade transparency data to the public and transaction data to competent authorities, removing barriers to non-discriminatory access to clearing facilities, the mandatory trading of derivatives on organised venues, specific supervisory actions regarding financial instruments and positions in derivatives and the provision of services by third-country firms without a branch.
- a new Directive (COM (2011) 656) (**MiFID II**), complementary to the proposed *MiFIR*, repeals the current Directive 2009/39/EC and amends specific requirements regarding the provision of investment services, the scope of so-called "*special exemptions*" from the current Directive, organisational and conduct of business requirements for investment firms, organisational requirements for trading venues, the authorisation and on-going obligations applicable to providers of data services,

⁴ Although recognising that the proposal increases transparency about OTC derivatives trading towards authorities as well as to the public, some criticisms have been levelled at the draft EMIR text (see [Vander Stichele, 2011](#)).

powers available to competent authorities, sanctions, and rules applicable to third-country firms operating via a branch ⁽⁵⁾.

Both proposals represent an essential vehicle for delivering on the G20 commitment to tackle less regulated and more opaque parts of the financial system, especially in those instruments traded mostly over-the-counter. In this sense, they complement the current legislation on OTC derivatives, central counterparties and trade repositories (the above-mentioned Regulation (EU) 648/2012 - *EMIR*).

A central aim of the *MiFIR* proposal is to ensure that all «pre» and «post» **trading derivatives** are conducted on regulated trading venues: *regulated markets*, *multilateral trading facilities* (MTFs) and *organised trading facilities* (OTFs) («pre» and «post» transparency). Obligations of this kind should allow for the elimination of, or at least the limitation of, the lack of information on the formation of prices and volume of trading on OTC derivative contracts.

The MiFIR lays the foundation for the transition of OTC derivatives trading to regulate the market, with it being subject to a system of regulation according to standardised procedures that are sufficient liquid. In this context, the proposals foresee the reinforcement of the role and powers of regulators in commodity derivatives markets. It will be for the ESMA to establish the degree of "*liquidity*". Furthermore, supervisors, in coordination with the ESMA, would be able to ban specific products, services or practices in case of threats to investor protection, financial stability or the orderly functioning of markets. The proposals introduce a **position reporting** obligation by category of OTC trader. This would help regulators and market participants to better assess the role of speculation in these markets. In addition, the Commission proposes to empower financial regulators to monitor and intervene at any stage in trading activity in all commodity derivatives, including in the shape of **position limits**, if there are concerns about disorderly markets.

Both law texts (MiFIR and MiFID II) should be finalised by the end of 2013 or the beginning of 2014.

The Market Abuse Regulations (MAR - CSMAD) and the revision of the UCITS Directive

Completing the *Barnier Package*, in 2011 and 2012, the Commission adopted [proposals](#) for a Regulation on insider dealing and market manipulation (*Market abuse - MAR*) and for a Directive to prohibit and criminalise manipulation of benchmarks (*CSMAD*).

The European Parliament endorsed the political agreement on Market Abuse Regulation on 10 September 2013. This Regulation updates and strengthens the existing framework to ensure market integrity and investor protection provided by the [Market Abuse Directive](#). EU rules will be adapted to the new market reality, notably by extending their scope to include all financial instruments which are traded on organised platforms and over the counter (OTC), and adapting rules to new technology. The manipulation of benchmarks will be explicitly prohibited, market abuse occurring across both commodity and related derivative markets will also be prohibited, and cooperation between financial and commodity regulators is reinforced.

Final adoption of the Market Abuse Regulation (MAR) should take place after a final political agreement on MiFID II, since aspects of the new European rules (notably its scope) depend on the final text of MiFID II and these will need to be aligned.

⁵ EP adopted some amendments on [MiFIR](#) and [MiFID II](#) proposals at first reading on 26 October 2012. The matters were referred back to the committee responsible for reconsideration and the vote was postponed until a subsequent plenary session. Some criticisms on the MiFID II have been published, in particular on position limits: see [SOMO \(2012b\)](#), [Friends of the Earth Europe \(2013\)](#) and [OFSE \(2013\)](#).

Furthermore, on 3 July 2012, the Commission adopted two new proposals:

- The first one amends the Directive 2009/65/EC on **Units of Collective Instruments in Transferable Securities** ([UCITS Directive VII](#)) regulating investment funds such as commodity ETFs (Exchange Traded Funds);
- The [second proposal](#) is about improving **transparency in the investment market for retail investors** and changes the key information documents for “*packaged retail investment products*” (*PRIPs*) (including investment funds and retail structured products) ⁽⁶⁾.

Implementation and effectiveness of reforms: new steps

The path forward for EU-US derivatives regulation

An essential condition for the **effective international application of reforms** decided at domestic level is **harmonisation of cross-border rules**. Successful completion of transatlantic coordination (EU-US) in cross-border swaps is particularly fundamental.

In July 2013, the [CFTC](#) and the [European Commission](#) reached a «*common path forward*» for cross-border swaps narrowing territorial scope, increasing mutual recognition and taking measures to avoid regulatory arbitrage.

Just one day after the CFTC and EC released their joint statement, the CFTC approved its highly-anticipated final interpretative guidance and policy statement on the cross-border application of the Dodd-Frank's swap regulatory requirements. The CFTC also approved a related exemptive order that will provide market participants temporary relief from compliance with some of these requirements.

General assessment of current reforms in the EU and the US

A recent study ([OFSE, 2013](#)) gives an overview of relevant EU and US regulation on commodity derivative markets. It also identifies the limitations of six main regulatory areas (see Table 1): transparency and reporting; regulation of **OTC**; **position limits**; price stabilisation instruments; **High frequency trading (HFT)**; and regulatory and supervisory powers.

Based on the OFSE's analysis, the EU and US regulations on commodity derivative markets have important limitations, in particular in the form of exemptions, which question their effectiveness. **Position limits** do for example not explicitly cover certain *types of trading* such as **OTC** in the EU (MiFID II) while the coverage of OTC trade in the US was rejected in court and remains contested (see Table 1.3). Exemptions could also include some *actors* at national level. *Commercial traders* as a class are usually exempted from many requirements. To date EU decision makers have only debated position limits on *individual traders*, as a percentage of the market, doing little to curb excessive speculation (MiFID II). In addition, limits exception could be applied to *treasury financing activities* which include investment banks ([Friends of the Earth Europe, 2013](#)).

In other areas, regulations were not even on the agenda, such as price stabilisation instruments (see Table), restrictions on certain trading strategies (e.g. index-based investments and technical/algorithmic trading) or actors (institutional investors) and volatility and large price swings ([OFSE, 2013](#): page 24). Only for **HFT**, EU proposals include explicit regulations while the US CFTC only installed a sub-committee for discussions on defining and regulating HFT (see Table).

According to OFSE ([OFSE, 2013](#): page 24), the most important regulations that are currently missing or not explicitly stated involve the following topics:

⁶ EU legislative developments could be followed in *Newsletter on EU Financial Reforms*, published regularly by [SOMO](#) and [WEED](#).

- Transparency/reporting of all commodity derivative transactions is incomplete, which makes the implementation and monitoring of position limits ineffective.
- Mandatory exchange trading with limited exemptions for commercial traders for genuine hedging activities is needed as well as clearing and security requirements for all commodity derivative transactions.
- Individual and aggregate position limits for commodity derivative trading have to be applied at the national and European level to prevent a group of traders distorting prices.
- A multi-tier Financial Transaction Tax (FTT) could be established in order to restrict very short-term trading (in this context, the current Commission's proposal for a FTT in the Euro-zone would be applied to all transactions, whether carried out on an exchange or OTC - see Table).
- Discrimination of harmful trading strategies (such as index-replication, technical/algorithmic trading and HFT) and/or certain actors (such as pension funds and other long-term investors) is required.
- Prohibition of proprietary trading by financial investors and commercial traders involved in hedging transactions for themselves and their clients.
- Market regulators should be granted effective intervention powers and sufficient resources to prevent market abuses; and, finally,
- It would be advisable to develop a multilateral regulatory authority with the objective of globally harmonized regulations, as well as strengthened coordination between regulatory and supervisory authorities.

TABLE 1. Overview of relevant US and EU regulation

Reform area	US / Dodd Frank Act	EU regulation and proposals
1. Transparency and reporting	<p>Already monthly aggregate data on traders' classes post-trade.</p> <p>Increased reporting requirements concerning OTC transactions and swaps:</p> <p>i) Obligations for real-time reporting of all cleared derivatives transactions; ii) all swaps have to be reported to data repositories and publicity post-trade.</p>	<p>MIFID: i) real-time reporting by traders of all derivatives that are eligible for clearing or required to be reported to trade repositories; ii) weekly public reports by trading platforms on positions classes of traders.</p> <p>EMIR: reporting obligation for all OTC derivatives to trade repositories.</p>
2. Regulation of OTC trade	<p>Clearing and trading requirements:</p> <p>All standardised OTC derivatives have to be cleared through CCPs and traded on registered platforms such as exchanges or exchange-like facilities. Exemption of non-financial entities when hedging commercial risks.</p> <p>Reporting all OTC derivative transactions to trade repositories.</p> <p>Margin rules for all non-cleared derivative transactions; possible exception non-financial entities hedging commercial risks.</p>	<p>EMIR: i) clearing obligation for standardised OTC derivatives; ii) improved risk assessment (margin rules) for all non-cleared OTC derivatives if exceed clearing threshold; iii) common rules for CCPs and trade repositories.</p> <p>MIFID: i) creation of "organised trading facilities" (OTFs); ii) bringing OTC trade to regulated exchanges, multilateral trading facilities (MTFs) or OTFs (trading obligation); iii) ESMA to define list of derivatives subject to clearing obligation that are also subject to trading obligation.</p>
3. Position limits	<p>Historically important but raised, circumvented or eliminated. OTC trade exempted.</p> <p>Regulators have to establish position limits, extended to set aggregate limits across all markets and trading platforms, including OTC, on all derivatives that perform or affect a significant price discovery function with respect to regulated markets.</p> <p>But financial lobbies filed a case against the implementation. Final decision pending.</p>	<p>Important in most regulated exchanges.</p> <p>MIFID: All trading venues, including regulated markets, multilateral trading facilities (MTFs) and "organised trading facilities" (OTFs), have to impose position limits but not OTC trade (EC proposal and EP position); Council position does not restrict to exchange-traded contracts, may include OTC.</p> <p>Exception for hedging purposes and treasury financing activity (latter only in Council position).</p>
4. Price stabilisation instruments	<p>Most exchanges have some price limits in form of circuit breakers or standstills.</p> <p>No further discussions on price limits and financial transaction tax.</p>	<p>Most exchanges have some price limits in form of circuit breakers or standstills.</p> <p>No further discussions on price limits. Possible introduction of a Financial Transaction Tax in 11 EU MS in 2014, in the procedure "enhanced cooperation" (which would also apply to derivatives) is still contested.</p>
5. Ban on certain trading strategies and actors: the High frequency trading (HFT)	<p>HFT: Not in Dodd Frank Act but CFTC sub-committee on algorithmic trading and HFT.</p> <p>No proposals on regulation yet.</p>	<p>HFT: i) minimum holding period of 500 milliseconds for position of regulated exchanges; ii) high fees for subsequently cancelled orders and for a high ratio of cancelled orders; iii) prohibition of direct electronic access to trading venues by investment firms.</p>
6. Authorities powers and international cooperation	<p>CFTC authority in certain areas strengthened.</p> <p>Some information sharing with foreign authorities.</p>	<p>ESMA and EC authority in certain areas strengthened.</p> <p>Some information sharing with foreign authorities.</p>

Source: [OFSE](#), 2013, pages 17-18.



Besides regulations on commodity derivative markets, also **broader financial regulations** would be required at European level. The 2008 crisis has led banks to turn increasingly to financial activity in order to build up their capital buffers. Commodities became a popular asset in the investment portfolio recommended by banks and other institutional investors. On this basis, future developments of the EU Banking Union could monitor the banks' commodity assets limiting systemic risks. Now, the Commission, implementing the «*EU financial services action plan*», is revising the [rules on banks' trading books and risk assessment management of trading](#).

Finally, **broader reforms in agricultural policies** would be necessary to mitigate the effects of commodity price volatility on farmers and consumers, at the local (national / European) and international (multilateral) level.

At the local level, we can mention that the CAP 2020 as well as the new US Farm Bill will reinforce risk management tools in order to deal more effectively with income uncertainties and market volatility.

At the international level, food security issues have been on the G20 agenda since the 2009 Pittsburgh summit ([Capitani, 2013](#); [Clapp and Murphy, 2013](#)). The first step was to support the **L'Aquila Declaration**, which committed G8 governments to spending \$22 billion in development assistance for food security over three years. The Cannes summit of November 2011 established a new "*Agricultural Market Information System*" (AMIS) to increase transparency with regard to available stocks in G20 member countries. The G20 members are even discussing about the possible establishment of grain reserves for humanitarian purposes.

In the current context, the [Ninth WTO Ministerial Conference](#) will be held in Bali from 3 to 6 December 2013. One of the official documents of the Conference is the G33 proposal enlarging the scope for public support in developing countries to include food purchases from small farmers to hold in stock and to use as domestic food aid. These proposals seek to remove such measures from WTO disciplines. In principle, the Bali Ministerial meeting would allow countries flexibility in implementing the G33 proposals on the basis of a waiver but with no formal legal exemption to existing WTO rules being granted ("*Green Box*").

Glossary

CCPS (Central-Counter-Parties): An entity that interposes itself between the counterparties to the contracts traded in one or more financial markets, becoming the buyer to every seller and the seller to every buyer.

Clearing: Each matched trade between a buyer and a seller generates two clearing trade transactions: one for the buyer and one for the seller. "Clearing" means the procedure which the "**clearing house**" becomes the buyer to each seller of a futures contract, and the seller to each buyer, and assumes responsibility for protecting buyers and sellers from financial loss by ensuring buyer and seller performance on each contract.

Clearing house: Administrative body of a market that guarantees the settlement of contracts. It becomes the counter party to the buyer and the seller of a contract when a trade has been matched, greatly reducing counterparty risk (see **CCPS**). It also makes sure that **underlying** financial instruments or commodities are actually delivered to fulfill futures contracts, and maintaining margin accounts.

Commodity derivatives: Commodity contracts that have commodities, such as oil, metals or agricultural products, as the **underlying**. One of the most important types of derivative is **futures contracts**. These are traded on **exchanges**.

Credit Default Swaps (CDS): Insurance contracts by which investors protect themselves in case of future defaults. For this guarantee the protection buyer pays a premium to the seller of the CDS and the seller is obliged to make a payment in the event of a default by the "insured". The contracts are thus used to transfer credit risks.

Derivative: A financial contract that gets (derives) its value from an **underlying** asset, such as stocks, bonds, foreign currencies, interest rates or commodity indexes. In fact, it is an agreement between a buyer and a seller that says how much the price of asset will change over a specific period of time. Derivatives contracts can be broadly categorised by the relationship between the underlying and the derivative. The main derivatives contracts are: **futures, options and swaps**

Exchange: A central marketplace with established rules and regulations where buyers and sellers meet to trade futures and options on **futures contracts**. The role of the exchange is important in providing a safer trade. The contracts go through the exchange's **clearing house**, which technically buys and sells all contracts. The value is that you know it will be executed, instead of having to trust a trader on the trading floor or some anonymous electronic trading platform. The exchange also makes contracts easier to trade, by making them "fungible". This means that they are interchangeable (as long as they are for the same commodity and delivery month, and have the same specifications for quality, quantity, delivery date, and delivery locations).

Exchange traded derivatives: They are products that are traded via exchanges. A derivatives **exchange** acts as an intermediary to all related transactions, and demands a deposit from both sides of the trade to act as a guarantee to potential credit risks.

Futures contract: A futures contract is an agreement to either buy or sell an asset on a publicly-traded **exchange**. The asset is usually a physical commodity, a stock index or a currency. The standardised contract specifies when it will be delivered and at what price. Most contracts are paid off before the delivery date.

HFT (High frequency trading): This term refers to a trading program that uses powerful computers to transact a large number of orders at extremely fast speeds. High-frequency trading often uses complex algorithms to analyse multiple markets and execute orders based on market conditions.

Options contract: A **derivative contract** that gives the owner the right, but not the obligation, to buy or sell a specific amount of commodity, currency, stock, index or debt at an agreed upon price within a certain period of time. The agreed price is called the **strike price**. The right to buy is called a "Call Option", and the right to sell is called a "Put Option". These are traded on **exchanges**. The **futures contract** that the long may establish by exercising the option is referred to as the **underlying** futures contract. The most widely used are stock options.

OTC (Over-The-Counter): It is an exchange directly between the buyer and the seller. Nearly 85% of all derivatives transactions are over-the counter. They are not listed on the **exchange** and there is no trade through third parties. The **European Market Infrastructure Regulation (EMIR)** requires that standardised OTC derivatives are cleared through a **central counterparty** in the



European Union in an effort to increase transparency and to reduce operational risk in the OTC derivatives market, which was identified as a contributing factor to the financial crisis. In 2010, the **US Dodd-Frank Wall Street Reform Act** already required most OTC derivatives be moved to an exchange.

Position limit (trading limit): .It is a pre-defined limit on the amount, or the maximum number, of derivatives contracts that a (legal) person, or a class of traders, can enter into or hold in one particular **underlying** security (e.g. hard red winter wheat futures) at a particular moment. Position limits can be designed by the **exchanges** on which the derivatives are traded, or by regulators and/or supervisors, and enforced by exchanges and/or supervisors. They aim at preventing excessive speculation and price instability

Spread price: Difference between the lowest offers price and highest bid price on the secondary market.

Strike price: The "strike price" (or "exercise price") means the price at which the futures contract underlying the **options contract** will be assigned upon exercise of the option. For options contracts which are exercised into multiple futures contracts, the "exercise price" represents the **spread price** differential between the **futures contracts**.

Swaps: The most common type of **derivative**. This is simply an agreement to exchange one asset for a similar one. The purpose is to lower risk for both parties. Swaps can be conducted directly by two counterparties, or through a third party such as a bank or brokerage house. The writer of the swap, such as a bank or brokerage house, may elect to assume the risk itself, or manage its own market exposure on an exchange. Swap transactions include "price swaps for commodities", "interest rate swaps" and "currency swaps". For example, a trader might sell a stock in the Euro zone and buy it in a foreign currency to hedge currency risk. In a typical "price swap commodity", parties exchange payments based on changes in the price of a commodity or a market index, while fixing the price they effectively pay for the physical commodity. These are **OTC**, or not traded on an **exchange**. The most infamous of these swaps were "**credit default swaps**" (**CDS**) because they also helped cause 2008 financial crisis. They were sold to insure against the default of municipal bonds, corporate debt or mortgage-backed securities (MBS). When the MBS collapsed in US, there wasn't enough capital to pay off the CDS holders. That's why the US Federal government nationalized AIG.

Trade repositories: The entities that centrally collect and maintain the records of trading of (**Over-the-Counter - OTC**) derivatives. These electronic platforms, acting as authoritative registries of key information regarding open OTC derivatives trades. Their purpose is to provide an effective tool for mitigating the inherent opacity of OTC derivatives markets.

Trading: The term "trade" mean any purchase or sale of any commodity **futures** or **options** contract made on the **exchange**.

Underlying: The stock, commodity, futures contract, or cash index against which a **futures** or **options** contract is valued.

For more **financial terminology**, see:

[Reuters - Glossary](#)

[CME Group - Glossary](#)

[LIFFE Investor - Glossary](#)

[SOMO - Glossary](#)

[US Economy - Glossary](#)

For an **overview of financial derivatives**, see also:

[CME Group - Overview of Derivatives](#)

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Author	Albert MASSOT, with the support of Filipa AZEVEDO and Guillaume RAGONNAUD, Policy Department B.
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