Applying the financial yardstick:

A survey of commodities and benchmarks in the Netherlands

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The Netherlands Authority for the Financial Markets

The AFM is committed to promoting fair and transparent financial markets.

As an independent market conduct authority, we contribute to sustainable financial prosperity in the Netherlands.

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1. Introduction

1.1 Benchmarks are vital to the world

The financial world could not survive without benchmarks[1]. In the commodity[2] sector, too, benchmarks play a key role in determining value. In the report "The financial yardstick applied: Dutch involvement with financial benchmarks" [3], published in February 2015, the Netherlands Authority for the Financial Markets (AFM) and The Dutch Central Bank (DNB) already concluded that considerable use is made of benchmarks in the Netherlands by a wide range of parties. Dutch financial as well as non-financial institutions provide input for setting commodity benchmarks, often simply because they carry out transactions in underlying markets and/or in the derivatives they use to hedge price risks. For this reason, it is important that the AFM zooms in on the commodity sector in the form of this exploratory survey.

As non-financial institutions account for a substantial part of the commodity market, it is important for the AFM as financial supervisor to obtain a reliable picture of the operation and the risks of the sector as a whole. Since the financial sector and the commodity sector are not comparable in all aspects, this survey of the commodity sector is of an exploratory nature.

Since 1 January 2015, the AFM has been supervising compliance with the prohibition against the manipulation of commodity benchmarks (see the section "Scope" below.) To give more substance to the supervision, the AFM is using this exploratory survey to obtain a clearer picture of the operation of the commodity sector and the (market-abuse) risks in relation to contributions to commodity benchmarks.

1.2 Global picture

Every year, global trading in commodity derivatives amounts to approximately 3,000 billion euro, with prices determined according to a benchmark. Physical trading (on the spot market) is sizable, too, with over 5,000 billion euro-worth being traded on the basis of benchmarks.[4]

On the importance of the commodity market, the International Organization of Securities Commissions (IOSCO)[5] has the following to say: *Market Authorities play a key role in ensuring*

[1] For the broad definition of a "benchmark", as also used by the AFM and DNB in their earlier survey of financial benchmarks, see the EU's Market Abuse Regulation at http://eur-lex.europa.eu/legal-content/NL/TXT/HTML/?uri=CELEX:32014R0596&from=EN.

[2] In the Netherlands, the term "raw materials" is often used where "commodities" is intended. As commodities are not things that only come out of the ground, "raw materials" has to be interpreted liberally. For the broad definition of "commodity", refer to the MiFID implementing regulation at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32006R1287:EN:HTML

[3] This is a joint report of De Nederlandsche Bank (DNB) and the Netherlands Authority for the Financial Markets (AFM). See http://www.afm.nl/nl-nl/professionals/nieuws/2015/feb/rapport-benchmarks

[4] See http://ec.europa.eu/internal_market/securities/docs/benchmarks/130918_impact-assessment_en.pdf

[5] Principles for the Regulation and Supervision of Commodity Derivatives Markets, Final Report, February 2011.

that physical commodity markets operate free from manipulation and abusive trading. They also play a critical role in responding effectively to disorderly market conditions.

1.3 The Netherlands

In the Netherlands, both the physical and the financial trading in commodities play a major role. This represents historical growth, thanks in part to the favourable geographic location and development of large ports in Rotterdam and Amsterdam. Consequently, the Netherlands is an attractive base for parties involved in commodity trading, resulting in various large commodity producers and traders having their head offices in the Netherlands. Among them are Royal Dutch Shell, Trafigura, Gunvor, Glencore and Cargill. Dutch banks, too, are global players active in commodity trading, mostly on the financing side. They extend loans to commodity producers and traders for mining and/or dealing in raw materials.

Fair and well-functioning commodity trading is important not only for producers, dealers and banks, but also for the consumer as end-user. The prices consumers ultimately pay for items such as petrol, electricity, bread and cocoa are set as part of the commodity trade and determined partly with the use of benchmarks.

1.4 Survey design

In the framework of this survey, the AFM held discussions with various parties, such as producers, users, traders, and storage and trans-shipping companies. Together with DNB, the AFM also studied the role of Dutch banks commodity trading, and held discussions with a hedge fund that conducts activities in this sector.

A number of the AFM's discussions were held jointly with the UK's supervisor of business conduct, the Financial Conduct Authority (FCA). The FCA supervises several key benchmarks (futures)[6]. Productive collaboration with the FCA is extremely important for the AFM, and *vice versa*. The discussions with Dutch banks were conducted jointly with DNB.

1.5 The sector says Libor has also impacted commodity trading

The risk of possible manipulation of prices on the financial markets as well as on the physical markets has also been a subject of discussion. The settlements relating to FX and Libor in the financial sector were also studied with interest by the commodity sector. As regards the parties that the AFM spoke to, they state they are now more aware of the risks of benchmark manipulation and of the importance of ethical conduct.

1.6 Commodity sector appears divided

In fact, the commodity sector does not exist. This is not a single market with a uniform way of marketing. It is a collection of sub-markets, each with its own players and dynamics. The parties we

[6] In July 2015, the FCA published a report on its findings concerning the financial sector and benchmarks. The FCA's conclusions are virtually identical to those the AFM and DNB reached in February this year. See https:/www.fca.org.uk/news/tr15-11-oversight-controls-in-relation-to-financial-benchmarks

have thus far spoken to have different things to say about manipulation risks. A common factor is that, above all, the interweaving of different activities (production, trade, storage, and processing) is seen as the source of a potential risk relating to manipulation.

1.7 Good practices

During our exploratory survey it emerged that, even though the parties were often not under direct supervision, they would appreciate receiving more guidance from the AFM on possible ways to reduce the risks of benchmark manipulation. In this report, the AFM presents five good practices that parties can use to reduce the likelihood of benchmark manipulation and other types of unethical conduct.

1.8 AFM scope

As of 1 January this year, the legislator included an explicit prohibition on benchmark manipulation in the Financial Supervision Act (also known by its Dutch acronym Wft)[7]. The AFM is the supervisor for compliance with this prohibition. It extends beyond benchmarks set in the Netherlands, to include those set elsewhere in the world that have a significant influence on the Dutch market. In carrying out this task, the AFM collaborates closely with other supervisors, such as the FCA.

1.9 Document overview

Section 2 provides descriptions of the leading benchmarks, as well as an outline of a typical chain (cocoa). Section 3 sets out the characteristics of the commodity trade. In sections 4 and 5, respectively, we explain the details of our survey and what our findings are. In sections 6, 7 and 8, respectively, we describe the content of the current regulations, the scope of the supervision the AFM performs, and the impact of the new regulations. Finally, in section 9, we provide a number of good practices and explain why it is important to implement them.

7 Section 5:58a of the Financial Supervision Act (Wft), Memorandum of Amendments to the Amendment Act FM 2015, TK 2013-2014, 33 918, no. 5, pp. 9 and 10.

2. What is a key benchmark?

A benchmark is a yardstick for price movements in an underlying market. If a market is important for the Netherlands, the benchmark for that market is too. Libor, the interest rate benchmark administered in London by the trading platform ICE, and Euribor, administered in Belgium by EMMI, are two examples of basic financial benchmarks. They are important because an interest rate is a main component of many types of contracts, two of them being loans and mortgages. These benchmarks were the subjects of earlier research the AFM and DNB carried out.

Some benchmarks for commodities, such as oil (Brent/Platts) and gold (London Gold Fixing) are set in a similar way to Libor and Euribor. Other benchmarks are set according to the prices of financial derivatives (futures).

2.1 Types of benchmarks

In commodity trading both submission-based benchmarks and transaction-based benchmarks are used, as well as a hybrid of these two.[8] Submission-based as well as transaction-based benchmarks are inherently vulnerable to manipulation. One reason for this is the fact that different parties, with divergent interests, are involved in setting the benchmarks. These conflicts of interests might be the interests an institution has versus those of its customers, or the interweaving of private and business interests of individual traders. This inherent vulnerability is a characteristic of financial benchmarks such as Libor, and of certain commodity benchmarks.

With submission-based benchmarks, the risk of manipulation increases if they are set using contributions from a small number parties who know each other, and when they are set on the basis of subjective input that is difficult to verify, such as estimates of commodity prices from panel members. The degree to which a benchmark's contributors know the method for setting it also increases the risk of manipulation.

With transaction-based benchmarks (futures for example), the risk of manipulation increases if setting the benchmark depends on a small number of parties with a combined large to very large market share. Another factor that increases the risk is a small time window for setting the benchmark, as this leads to sizable transactions having a relatively large effect. The above risk characteristics are particularly relevant for commodity trading.

Benchmarks can be set according to the transactions a party has executed or to other information a party has published on its website. The administrator that uses the information to set a benchmark will not always explicitly ask for a contribution. A contributor is a party that provides the administrator with prices, values, estimates or positions. Market parties can also become contributors simply by engaging in transactions. They have to be alert to other parties using their information. At the very least, they have to be aware that they contribute to a benchmark, as well as of the responsibilities this entails. These can be both legal as regards market abuse, and contractual to the benchmark administrator.

[8] For a more detailed description of these types of benchmark, see the earlier report published by the AFM and DNB: https://www.afm.nl/nl-nl/professionals/nieuws/2015/feb/rapport-benchmarks

A major challenge both for financial institutions and for parties actively engaged in commodity trading is to identify the benchmarks in which they are involved.

2.2 Key benchmarks for the Netherlands

Among the commodities, energy is one of the fundamentals of the economy. Many sectors depend on energy, while for all consumers it is of direct importance. The price of oil is reflected in the price car owners pay for petrol, and the prices of gas and electricity (energy commodities) determine their monthly energy bills. [9]

For a number of commodities, the trading data from the physical market are used as benchmarks, crude oil for example. For other commodities, the prices of the respective derivatives determine the benchmarks. This is the case with the futures of several metals quoted on the LME.

Energy benchmarks are therefore important for the Netherlands. Many of them are administered by Platts, Argus and ICIS, reporting agencies all based in London. In the Netherlands, the prices for gas and electricity are set on the ICE ENDEX and APX platforms. Agricultural benchmarks, such as for grain and cocoa, also significantly impact Dutch industry and consumers. The Netherlands is a major transit hub, with some large traders and producers having their bases here. The prices for these types of commodities are directly reflected in the prices consumers ultimately pay for groceries, such as bread or chocolate. These benchmarks are administered by ICE (London), Liffe (London), CBOT (Chicago), CME (Chicago), and Matif (Paris).

As a final point, metals, especially aluminium, are also very important. Aluminium finds its use in all manner of products, from cars to cans. The main administrator for metal-related benchmarks is LME.

The larger part of the European trading in derivatives is conducted on platforms such LME, Liffe and ICE.

2.3 Gold and silver

Considerable international attention has also been directed to the integrity of gold and silver benchmarks, mainly by North American, UK and Swiss supervisors.[10] For Dutch parties and the Dutch economy, however, these benchmarks appear to be of secondary importance.

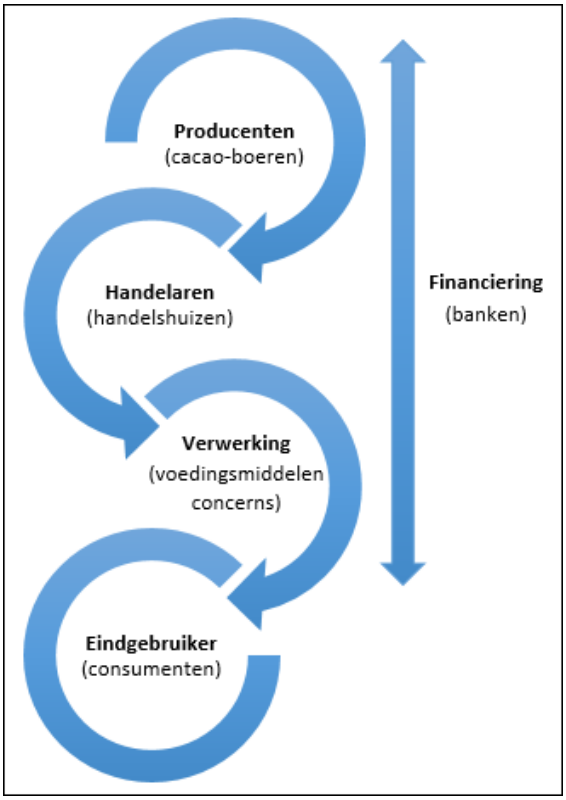
[9] Another example is the possible refund for the solar and/or wind energy they generate.
10 See for example CFTC's investigation into silver, at http://www.cftc.gov/PressRoom/PressReleases/pr6709-13

2.4 An example chain

The Netherlands plays a major role in the international processing and trans-shipping of cocoa. By way of illustration, in terms of the amount of cocoa processed and shipped each year, the Port of Amsterdam leads the world.

The graphic in the box below shows the chain of players in the cocoa market.

In the first link of the chain, the cocoa beans are harvested by **producers,** mostly small, local farmers. **Traders** purchase the beans and ship them to markets all over the world. Specialized companies process the beans to make semi-finished products, such as cocoa butter. Food companies then **process** the cocoa butter to create products suitable for consumption (chocolate, biscuits, etc.). These products are ultimately sold to consumers (**end-users)**. In the background, banks play an important role in **financing** the trade. Within this diagram of activities, certain parties might specialize in a particular activity, or combine two or more in their business model.



Producers (cocoa farmers)		
Traders (trading firms)		Financing (banks)
Processing (food processing companies)		
End-user (consumers)		

3. Characteristics of commodity trading

3.1 Commodity trading characteristics

The commodity sector has a number of significant characteristics. For example, it encompasses a widely divergent range of physical commodities, financial instruments, trading platforms and players.

Regarding this diversity within the sector, IOSCO[11] says the following: *The occurrence of multi-market trading abuses which have involved commodity futures, OTC derivatives and physical commodity markets, requires that there be a Market Authority in the IOSCO Member's jurisdiction charged with the responsibility to actively conduct surveillance and enforcement to detect and prosecute such abusive schemes. Although no Market Authority can prevent every market abuse, credible efforts are necessary.*

A second characteristic is that the trading in physical commodities is largely bilateral.

The trading can be distinguished from that in shares, as substantial parts of the physical as well as the financial trading do not take place on regulated markets, but occur bilaterally (in the form of OTC transactions).

Accordingly, benchmarks are used extensively to determine the price of commodities and of derivatives.
A third characteristic is the tight interconnectedness of the market in physical commodities with the market in commodity derivatives. By value, the size of the trade in derivatives is generally a multiple of that in physical commodities.

Trading in physical commodities is tightly interwoven with the trading in derivatives. Many parties are active in both parts of the market, their derivative transactions often intended as hedges against the market risk of physical trading.

Typical of the markets for commodity derivatives are the many expiration dates, establishing many sub-markets, all with different prices. To illustrate the point, the market in WTI Crude Oil futures has an expiration date every month for the next three years. Although most of the trading is in futures with the shortest term, there are also transactions every day in futures with longer terms. Each expiration date represents a separate sub-market with its own supply and demand, and its own resulting price.

On the markets for physical commodities, there is also a wide range of prices. In this case, the cause is not expiration dates, but, for example, the quality of the commodities concerned, seasonal influences such as the weather, or delivery location.

A trend in the market is the tendency for parties to want to trade as closely as possible to the settlement price (the benchmark). This leads to a high volume, usually at the close of the trade. Around the time the settlement price is fixed, remarkable price movements are sometimes seen. This is very clear from the example in the figure below.

[11] Principles for the Regulation and Supervision of Commodity Derivatives Markets, Final Report, February 2011, p. 62.

A major difference between commodity trading and share trading is the absence of *retail investors*. The investors trading in the commodity markets are mainly professionals.

3.2 Risks of benchmark manipulation

From discussions with market parties on the risks of benchmark manipulation in commodity trading, a number of points stand out. In general, parties realize that commodity trading is exposed to a higher risk of manipulation than other markets, because the market is highly differentiated. Consequently, certain illiquid niche markets exist. Being illiquid, these markets present the risk of parties involved in transaction-based benchmarks being able to influence the benchmark. The parties could then benefit from this through trading activities on financial markets, or vice versa.

Parties also acknowledge the inherent risks at companies that engage in trading alongside storage activities. Interweaving of these two activities can lead to a company using its storage operation to influence the prices of certain physical goods. It can then benefit from this through its trading operation by concluding futures contracts on the financial market.

The parties we spoke to cite the interweaving of traders and storage firms as presenting one of the greatest risks of manipulation. Such an interweaving formed the background to the aluminium queues[12] and has allegedly been a factor in the Qing Dao fraud[13] with warehouse certificates.

A study conducted by IOSCO emphasises that the commodity trade (like the interest rate market) is vulnerable to benchmark manipulation because the contributors to a benchmark as panel members can use that same benchmark for contracts they buy and sell. It also states that the commodity trade is a relatively small world, in which a few large parties have a great deal of influence. In this situation, there could be an interweaving of parties that set a benchmark (administrators) and the users of that benchmark.

The AFM sees these findings by IOSCO as confirmed by the discussions we conducted, with the parties to these discussions citing the same risks. To prevent such manipulation, it is important that market parties are fully aware of the above risks and keep their companies in order as regards ethical and controlled business dealings. The AFM therefore recommends that measures be taken to mitigate the above-mentioned risks. In section 9, the AFM provides a number of tools for tightening up business conduct in this context.

[12] US Senate Report on Wall Street Bank Involvement with Physical Commodities, pp 169 et seq.
[13] See among others http://www.bloomberg.com/news/articles/2014-12-03/citigroup-panicked-over-fraud-at-chinese-ports-mercuria

4. Our survey of the commodity sector

The parties that trade directly on the physical and financial commodity markets are extremely varied, very large, and hence not easy to classify. To simplify the reading of this report, we divided them broadly into trading firms, producer-traders, user-traders, banks, and storage and trans-shipping companies. For our survey, we spoke with parties from each of these categories. In the discussions, we posed questions on subjects ranging from operating activities to contacts with supervisors, as well as on the use of benchmarks and manipulation risks within the sector. We briefly describe below what the parties in each category do.

4.1 Trading firms

The *core business* of a trading firm is the physical trade in raw materials and/or energy. They make a profit by buying commodities at location A, shipping them (or having them shipped), possibly processing them to some extent, and eventually selling them at location B. The downside price risk is hedged on the financial markets with futures, forwards and other similar instruments. By using this strategy, trading firms shield themselves against a fall in price of a physical commodity between buying and selling.

Generally, these parties have their own proprietary trading desks for trading on the financial markets for their own account and risk. This is in addition to trading on the financial markets to create a hedge against price risk. Parties say that this trading for their own account is negligible compared with the hedging activities they undertake.

4.2 Producer-traders

Producer-traders engage in the production/mining/acquisition of physical commodities and their sale. They, too, hedge the downside risks of their positions by taking positions in derivatives on the financial markets. These parties also trade on the financial markets for their own account and risk. Most of the discussion partners say that the extent of this activity is limited compared with the physical trading and the hedging activities.

4.3 User-traders

For user-traders, the availability of commodities at fixed prices is often the important thing. These parties very often cannot predict what their actual usage will be. They secure part of their predicted needs by concluding long-term purchase contracts, under which the purchase prices are usually linked to a benchmark (Platts for example). As for the remaining part – and possibly to fill their customers' needs – they make purchases on the spot market. They hedge the upside risk with derivatives. In addition, they often operate a proprietary trading desk on the financial markets for their own account and risk.

4.4 Banks

Banks in the Netherlands are no longer active in the physical markets. Their main involvement is to finance commodity trading conducted by large trading firms. In this area, Dutch banks are among the world's biggest players.

DNB in its Newsletter for Banks of 11 December 2014 said that banks should devote more attention to the inherently high integrity risk in commodity trade finance[14]. This aspect of the commodity sector, the financing, falls outside the scope of our survey, however.

Dutch banks are active on the financial markets to hedge the price risk to which customers are exposed. They also trade in derivatives on the financial markets for their own account and risk, but only on a small scale. Most of the parties add, though, that this activity is steadily decreasing.

4.5 Storage and trans-shipping companies

The storage and trans-shipping companies the AFM consulted do not engage in trading on the physical or financial markets. They usually provide just one service, the storage of goods. In principle, they possess sensitive information. Because of the service they provide, they know what goods each customer is storing and the amounts in storage. To date, the AFM has received no indication that these companies are treating the information other than prudently.

4.6 Hedge fund

In connection with this survey, the AFM also spoke with a hedge fund that invests actively and restricts its trade in commodities to derivatives. As a typical party that seeks a risk premium, the fund tends to hold short rather than long positions. Such parties focus on medium-term trends, and do not trade in physical commodities.

Some parties, such as speculators and investors, trade exclusively on the derivative markets. Other parties, such as producers, trading firms and buyers, are deliberately active in both markets.

4.7 Pension administrators

In the Netherlands, there are several large pension administrators. They, very often, hold large open positions as an investor in commodities. We did not include these parties in our survey, however. As part of its continuous supervision of compliance with the prohibition on the manipulation of commodity and other benchmarks, the AFM will hold discussions with these parties in 2016.

[14] See http://www.dnb.nl/nieuws/dnb-nieuwsbrieven/nieuwsbrief-banken/nieuwsbrief-banken-december-2014/dnb316105.jsp

5. Findings

5.1 The commodity sector appears divided

It is striking how differently the parties talk about manipulation risks. One thing they do appear to agree on is the potential risk entailed by the interweaving of different activities.

It was suggested a couple of times that speculators might engage in manipulation, without stating how they would do this or which entities were meant. A large trading firm said it was actually pleased there were speculators active in the markets for commodity derivatives, as they could provide the necessary liquidity. This represents added value, given that some of these markets are highly illiquid. Another comment was that speculators are also partly responsible for rising prices. Some parties see this as negative, others as positive, depending on the individual party's perspective.

For banks and hedge funds, the greatest risk of manipulation is from parties that trade in physical goods and are also active in financial markets. However, it is these same parties that point out the necessity of using the financial markets to hedge the risks they face from trading in physical goods. In their view, this is an inherent feature of trading in physical goods.

If the positions on the derivative markets are a logical consequence of the actual trading or production activities, as well as being comparable to the physical trading positions in terms of size, this does appear to be hedging. However, if purely financial companies enter the same derivative markets, while actively trading in physical commodities, this presents a high risk of manipulation.

Another risk pointed out is the interweaving of storage and trading. The storage and trans-shipping companies the AFM has consulted so far do not engage in trading on the physical or financial markets.

The parties that trade in physical commodities stress the importance of well-functioning financial markets. All these parties need the financial markets to hedge their price risks, meaning that sufficient liquidity in the relevant sub-markets is essential for them.

The big trading firms in particular are aware they are often held responsible for the large price fluctuations on the commodity markets. This is unjustified as far as they are concerned (and due to "*sheer ignorance"*). They point to the many unpredictable factors in commodity trading, such as weather, crop failures, labour disputes, and boycotts and other political uncertainties, each of which can have a huge impact on price formation. Moreover, they claim they only hedge their own price risk. They say they never take a larger position than one matching their position in physical commodities.

The smaller players point to the limited scale of their own activities and lay the blame at the door of the large parties.

The trade in commodities and commodity derivatives is considerably more judgement-based, because the risk management involves many unpredictable variables (weather, crop yields, etc.). There is less standardization of financial instruments, one reason being the extensive use of forwards (non-standard OTC instruments). Clear structuring exists much less here than in purely financial markets, such as the equity market.

5.2 Post-Libor

We discussed the possible manipulation of prices on the financial markets and the physical markets with all parties. Although it concerns a different sector, most parties say they have followed with interest the Libor and FX investigations and settlements in the past few years. The parties we spoke with say that they monitor their own traders more often than before (regarding chats and unusual trades), now have a more prudent recruitment policy (concerning type of employee), and are more conscious than previously of the need for the remuneration policy to encourage compliant conduct.

5.3 Criticism of administrators

As a final point, it struck the AFM how often criticism was expressed about the administrators of frequently used benchmarks. Many of the parties the AFM spoke to referred to the unclear way that prices are set on the platforms. Large and small parties alike voiced this criticism, pointing to the potential for price manipulation.

It should also be noted that, at the end of last year IOSCO acknowledged that the three PRAs (Price Reporting Agencies) had made progress regarding compliance with the principles intended to improve the integrity of benchmarks.[15] As these parties must soon have a licence under the EU's benchmark regulation, they will have a legal obligation to ensure that the methods used to set benchmarks are robust and transparent, and that any conflicts of interest are properly resolved.

[15] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD448.pdf

6. What are the existing rules?

Currently, there are general rules for trading and for the conduct of financial companies. These are enshrined in the Wft, with their roots in EU regulations, namely MiFID and MAD. Although these two Directives do not directly apply to benchmarks, they formed the basis for developing international principles governing contributions to and administration of benchmarks.

As from 3 July 2016, MAR will prohibit the manipulation of benchmarks anywhere in the European Union.[16] In the Netherlands, this has already been the case since January, in anticipation of MAR. The prohibition also applies to entering into transactions used for setting a benchmark.

6.1 Remit

Specifically for the energy markets, Remit[17] makes it clear that the manipulation of reference prices is also within the scope of the prohibition on manipulation. Remit is an EU Regulation, the name standing for Regulation on wholesale Energy Market Integrity and Transparency. To guarantee integrity and transparency, and prevent insider trading and market manipulation, every company that engages in trading is under an obligation to register with ACER via its National Regulatory Agency.

Moreover, pursuant to Article 8 of Remit, these European Market Participants (MPs) as registered energy traders (roughly 400) will have to report all their wholesale orders for energy and transactions executed in an Organized Market Place to ACER as from 7 October 2015, using a selected Registered Reporting Mechanism. This is the first reporting step for registered MPs, with the second step coming into force on 7 April 2016.

In addition, supervisors, trading platforms and brokers will utilize their surveillance systems to be more active in tracking down market manipulation. The aim is to further discourage manipulation and insider trading. The AFM is closely involved in this detection process.

6.2 IOSCO

IOSCO has issued principles for the administration and use of benchmarks.[18] In September 2013, the G20 (19 countries plus the European Union) endorsed these principles. In February 2015, IOSCO published its findings on compliance with these principles.[19] As a further measure, steps have been taken internationally to make submission-based benchmarks less vulnerable to manipulation.[20]

16 http://eur-lex.europa.eu/legal-content/NL/TXT/HTML/?uri=CELEX:32014R0596&from=NL

17 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:326:0001:0016:nl:PDF , preamble 14.
18 Principles for the Regulation and Supervision of Commodity Derivatives Markets, Final Report, September 2011. Downloadable from http://www.iosco.org/library/pubdocs/pdf/IOSCOPD358.pdf and www.iosco.org/library/pubdocs/pdf/IOSCOPD415.pdf

19 www.iosco.org/library/pubdocs/pdf/IOSCOPD474.pdf
20 Among them are steps taken by the FSB following an IOSCO review. See http://www.financialstabilityboard.org/2014/07/r_140722/ and http://www.financialstabilityboard.org/2014/07/r_140722a/

6.3 EBA and ESMA

In Europe, the supervisors European Banking Authority (EBA) and European Securities and Markets Authority (ESMA) have published principles for banks that contribute to benchmarks.[21] DNB and AFM were involved in the development of these principles, and both endorse them.

6.4 United States

Just as in Europe, trading platforms in the United States of America need to make sure they only allow trading of benchmark-based derivatives if the underlying benchmark is sufficiently robust.

6.5 United Kingdom

It was decided in the United Kingdom to place Libor and seven other benchmarks (SONIA, RONIA, WM/Reuters 4p.m., ISDAfix, London Gold Fixing, LMBA Silver Price, and ICE Brent Index) under the supervision of the FCA, and transfer their administration to an independent party.[22] This was prompted by the Wheatley Report, which included the FCA's investigation into Libor (including how it is set) and recommendations on the supervision of benchmarks.[23]

21 http://www.esma.europa.eu/system/files/2013-659_esma-eba_principles_for_benchmark-setting_processes_in_the_eu.pdf
22 See http://www.fca.org.uk/news/fca-to-regulate-seven-additional-financial-benchmarks and www.bankofengland.co.uk/markets/Documents/femrjun15.pdf
23 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/191762/wheatley_review_libor_final_report_280912.pdf

7. Scope of AFM supervision

Together with the AFM and DNB, the Ministry of Finance considers it essential that benchmark manipulation be tackled effectively in order to protect market parties and safeguard trust in the financial markets. Accordingly, the AFM received explicit powers on 1 January 2015 to take action against the manipulation of benchmarks. As such, the Netherlands is ahead of EU regulations. These powers are embodied in Section 5:58a of the Wft.

In brief, this Section provides the AFM with powers regarding benchmark manipulation if:
- the impact of the manipulation is somewhere in the Netherlands, in an EU Member State, or in a country outside the EU; or
- the impact of the manipulation is in another EU Member State, but the manipulation took place inside the Netherlands.

The above-mentioned powers to act against benchmark manipulation were deliberately defined broadly by the legislator. Not only do they apply to benchmarks such as Libor, but to commodity benchmarks as well. And not only to benchmarks administered in the Netherlands, but also to those administered elsewhere in the European Union, or in other countries. The criterion is the extent to which the manipulation has a significant impact on the Dutch market.

As discussed earlier, the Netherlands is mainly home to physical trading. Traders protect themselves against the accompanying price risks by means of *hedge contracts* on the futures markets. This trading in futures takes place mainly in London. For this reason, the AFM maintains close contact with the FCA, one of whose duties is supervision of the futures markets in London. As an example of this contact, the AFM regularly exchanges information about indications of possible manipulation.

7.1 Reporting suspicions to the AFM

As part of its supervisory activities, the AFM utilizes signals it receives from the market. We would therefore like to hear from market parties if they suspect there is manipulation or unusual trading behaviour in the markets where they are active. This can also include other types of market abuse, insider trading for example.

On this point, we stress that market parties can also contact the AFM even if they are not certain. In other words, the AFM wants to keep the threshold as low as possible for market parties to report unusual orders or transactions. To this end, the AFM operates a *desk*, the STR desk, for receiving *suspicious trading reports*.

Reports

If undesirable market conduct is occurring, the AFM wants to know about it. The slightest suspicion of market abuse is good enough for sending an email to STR_desk@afm.nl or calling +31 (0)20 7973716.

If the AFM suspects manipulation, it can start an investigation. We study each and every report. For initiating a more thorough investigation, however, the AFM carries out a risk-based assessment.

Motivation for this can be the actual or potential impact of the manipulation on the Dutch market. When conducting an investigation, the AFM also has the power to demand information and carry out on-site inspections, possibly unannounced. If the AFM establishes that benchmark manipulation has taken place, it can impose an administrative penalty or report the offence to the Public Prosecutor.

8. What are the new laws and regulations?

The rules applying to the EU markets for commodities are being tightened. Trading is becoming more transparent, and a larger part of it will take place on regulated platforms. Moreover, more parties that are active on these markets will have to have a licence or have to register with the appropriate supervisory authority. The rules governing trading are also going to become stricter. In addition, the administration of benchmarks, including those for commodity derivatives, will be regulated and licensed.
Most of the rules are still under development. An exception is the prohibition on benchmark manipulation, which is already in force in the Netherlands.

8.1 Benchmark Regulation

For benchmarks, commodity benchmarks included, the most important piece of legislation is the Benchmark Regulation. It is currently the subject of negotiations among the European Parliament[24], the Council of Europe[25] and the European Commission. Agreement on this legislation is expected before the end of the year, although the date of its entry into force is still uncertain. Pursuant to the Benchmark Regulation, administrators of benchmarks will have to be licensed, or at least have to be registered with the appropriate supervisory authority. Market participants that submit data for setting a benchmark are going to be required to sign a code of conduct. Financial institutions will only be allowed to use benchmarks if they adhere to the EU rules.

Update: The negotiations between the European Parliament, the Council and the Commission have been completed. The final text of the Benchmark Regulation has been published.[26] It is currently awaiting publication in the Official Journal, 18 months after which it will apply.

8.2 MiFID/R and EMIR

For commodity derivative markets, MiFID and MiFIR,[27] and EMIR[28] also are relevant. Although these pieces of legislation do not directly apply to benchmarks, they will have far-reaching consequences for the trading in commodity derivatives. EMIR was drawn up to make the market in OTC derivatives safer and more transparent. Under EMIR, every derivative contract has to be reported to a Trade Repository. In addition, derivative contracts will have to be cleared centrally through central counterparties (CCPs) for the purpose of controlling counterparty risk. The first commodity derivative contracts will soon be subject to these constraints as well.

The primary objective of MIFID/R is to curtail the exemption to the licensing obligation, leading to more parties and new types of parties requiring a licence. Parties that trade relatively frequently in commodity derivatives and parties that have a relatively large presence in their markets will have to have a licence. Precisely which parties are caught is not yet clear. ESMA is currently preparing

24 http://register.consilium.europa.eu/content/out?lang=en&typ=SET&i=ADV&RESULTSET=1&DOC_ID=8646/15&DOC_LANCD=EN&ROWSPP=25&NRROWS=500&ORDERBY=DOC_DATE+DESC
25 http://register.consilium.europa.eu/doc/srv?l=EN&f=ST%205921%202015%20INIT
26 http://data.consilium.europa.eu/doc/document/ST-14985-2015-INIT/en/pdf
27 https://www.afm.nl/nl-nl/professionals/onderwerpen/mifid-ll.
28 http://www.afm.nl/nl-nl/professionals/onderwerpen/emir

advice for further technical details of the rules.[29] Irrespective of the outcome, every party active in these markets will have to inform the AFM accordingly.

In common with EMIR, MiFID mandates the reporting of transactions in commodity derivatives, with the onus on investment firms to carry this out.

8.3 Position limits

Another feature of MiFID is the application of a regime of position limits and position reporting. Every party actively trading in commodity derivatives will have to adhere to the limits. All such derivatives will have a limit, the size to be set in 2016. ESMA is currently defining the framework for setting these limits.[30]

8.4 MAR

MAR comes into application on 3 July 2016, placing a prohibition on the manipulation of benchmarks within Europe. It also includes a substantially strengthened system of penalties. MAR provides for a maximum penalty at the level of the Member States of no less than € 15 million or 15% of the total annual revenue of a legal entity that is guilty of manipulating a benchmark.

In discussions with the AFM, various trading firms expressed their concerns about the new EU regulations:
They consider it unjust that commodity traders are viewed as flawed parties that have to be regulated. The financial markets are significantly different from the commodity markets, yet the EU legislation does not take this sufficiently into account.

[29] http://www.esma.europa.eu/page/Markets-Financial-Instruments-Directive-MiFID-II
[30] http://www.esma.europa.eu/page/Markets-Financial-Instruments-Directive-MiFID-II

9. Good practices

The international commodity sector has already been investigated several times for unethical conduct, often in connection with the influencing of commodity prices. A number of cases concerned what we would now consider as benchmark manipulation under Section 5:58ae of the Wft.

In our report of February this year, we defined ten *good practices* for financial institutions to prevent and detect benchmark manipulation. Although many of the parties we spoke with do not have to meet the requirements for ethical and controlled operations that the Wft lays down, they specifically mentioned they would welcome similar guidelines from the AFM. Based on our survey, we have selected five *good practices* and tailored them to fit the sector. By issuing these five *good practices*, we aim to achieve two things. On the one hand, reduce the likelihood of commodity prices and benchmarks being manipulated, and on the other, establish a foothold for strengthening the supervision of this sector. The *good practices* therefore constitute guidelines for the supervisor as well as for the parties concerned.

In the opinion of the AFM, the tightening of business operations by means of these *good practices* and other measures will reduce the risks of unethical conduct.

List of good practices

1. The *three lines of defence* embody a high level of knowledge and risk-awareness relating to prices and the benchmarks to which the party contributes.
2. The policy for price formation (for benchmarks) is implemented and adhered to by all business units and at all locations of the party.
3. Adequate and constant monitoring of transaction and communication data helps ensure ethical conduct at the party and prevents unethical conduct relating to *conflicts of interest*.
4. Managing with the aim of preventing integrity risks arising in the workplace (*tone at the top*) demands continuous attention to encouraging desirable conduct and discouraging undesirable conduct
5. When selecting a counterparty, account is taken of known unethical conduct such as price or benchmark manipulation. A counterparty is challenged to explain unethical conduct that is detected.

9.1 Good practice 1

Most parties employ the *three-lines-of-defence* model (business, compliance and audit). Whether all three lines embody the same high level of knowledge and risk-awareness relating to prices and the benchmarks to which the party contributes is something the AFM is unable to determine from this survey. Even more than at financial institutions, the knowledge and expertise at parties in the commodity sector are very explicitly possessed by individuals with their own responsibilities and targets. Knowledge bundling is important to guarantee the same high level of knowledge for all *lines of defence*.

9.2 Good practice 2

Virtually all the parties the AFM spoke with have more than one location as well as offices in all parts of the world. This makes it important to ensure that the policy for price formation (for benchmarks) is not centralized or remains limited to the head office. Every location must know where to find the policy, understand it, and be able to follow it in practice.

9.3 Good practice 3

One widely recurring theme during our discussions with the commodity sector was that it, too, was aware of the Libor scandal. Our discussion partners remarked that the manner of internal communication has changed since Libor.

To keep the market clean and be able to quickly detect unethical conduct, it is important for parties to monitor transaction and communication data. This is possible with the use of alerts and/or *red flags*.

9.4 Good practice 4

It is not only the financial sector where the *tone at the top* is extremely important. The commodity sector also benefits from the right tone. Employees copy not only their *colleagues'* behaviour, but also that of senior managers. In order to have the right tone sound throughout the company, integrity sessions together with senior managers can be organized, or, for example, senior managers can use blogs or meetings to reinforce the desired company culture.

9.5 Good practice 5

A remark often heard is that it is counterparties that engage in unethical conduct. From a number of parties taking part in the survey we heard that they have an exit script available. This is a script employees can use to break contact quickly and efficiently with a counterparty that has unethical intentions. Another thing parties can do is start to prepare a *sustainability ladder* for their counterparties.

9.6 Next steps

This survey of the commodity sector has provided the AFM with a global picture of how this market functions in relation to benchmarks. The survey did not extend to enquiring into the policy and procedures of the participants, or checking how effective they are in practice.

In this regard we point out that the AFM has taken good note of a report[31] recently published by the FCA. It deals with the extent to which parties in the commodity sector have embedded procedures and controls to combat market abuse. One of the FCA's conclusions is that the parties concerned have so far not put all the lessons learned from the Libor settlements into practice.

With the FCA's report as added motivation, the AFM will turn its attention again to the commodity sector in 2016. This time it will examine whether the parties concerned have sufficient policies to

[31] https://www.fca.org.uk/static/documents/newsletters/market-watch-49.pdf

prevent benchmark manipulation, and check whether these policies are also effective in practice. The AFM will also examine the extent to which the good practices presented in this report are being adopted. In parallel, the AFM will focus on picking up signals from parties in the commodity sector concerning possible market abuse. At the end of the day, it is important for all concerned that commodity markets and financial markets operate honestly. This therefore creates a common responsibility for active parties and the supervisor to contribute to achieving the aforementioned goal.

The Netherlands Authority for the Financial Markets
T +31 (0)20 7972000 | F +31 (0)20 7973800
Postbus 112723 | 1001 GS Amsterdam
www.afm.nl