MEP briefing

Effective reforms for stable food prices

Closing the loopholes in MiFID

July 2013

- **Excessive financial speculation in commodity derivatives has significantly increased price volatility and inflation for staple foods and other commodities. This has had negative impacts for consumers and businesses in Europe and has contributed to significant increases in hunger and poverty globally.**
- **Position limits are needed to curb speculation. They are the norm for regulating commodity markets around the world, and must be made mandatory in Europe through the current review of the Markets in Financial Instruments Directive (MiFID).**
- **The current negotiating texts propose position limits but there are many loopholes which would render these limits ineffective. As decision-makers enter the final stage of negotiation on these proposals, they must act to remove key loopholes to ensure position limits are not undermined and are effective to control excessive speculation.**

High and volatile commodity prices

Since deregulation in the 1990s, financial speculators' share of major commodity derivative markets including basic foods such as wheat and maize has risen dramatically. For example, the share of the wheat market held by speculators increased from 12 per cent in 2006 to over 60 per cent in 2011. Over this five-year period, the value of assets held by financial institutions in the agricultural commodity markets nearly doubled, from US$65 billion to $126 billion.

While food prices are affected by a range of factors, there is now broad consensus that excessive financial speculation has increased food price volatility and contributed to price spikes such as those witnessed in 2008 and 2011. Indeed, some academics argue that recent food price volatility is now more closely correlated with activity in financial markets than with agricultural supply and demand.

The influence of financial speculators is not just limited to the recent food crises. In June 2011, a report for the G20 by international organisations including the IMF and the OECD noted that too much speculation *"can cause frequent and erratic price changes"*. A panel of experts for the UN Food and Agriculture Organisation went further, stating that *"tighter regulation of speculation is necessary."*

While there is a role for some speculation in these markets in order to provide adequate liquidity for those who use the markets to protect themselves from price fluctuations, such levels have been far exceeded. Speculation is now fuelling price volatility, and in doing so pushing low-income consumers into hunger and poverty.

Limits to curb excessive speculation

Position limits cap the number of contracts of a particular commodity that a trader (or group of traders) can hold. This prevents traders from 'cornering' a market, or exerting an excessive influence on prices.

Position limits have a track record of effectiveness, having been used in the US for most of the twentieth century. They are being reintroduced there following the disastrous impact of deregulation, and are used in commodity markets around the world including Japan, Hong Kong, Singapore, China, Australia and South Africa.

Position limits are transparent and give traders legal certainty. It is normal for position limits to be reviewed on a regular basis to ensure that they respond to changes in the market.

By contrast, position management systems which rely solely on self-regulation by exchanges have failed to prevent even clear incidents of market abuse. For example, in July 2010 the hedge fund Armajaro was able to buy up almost the entire European cocoa supply through the London-based exchange, pushing prices to a 33-year high. This prompted a group of European industry figures to warn that they would move their business to the US without better controls to prevent such abuses.

By definition, position management systems introduce a conflict of interest, since exchanges make money based on the volume of trading they handle, and so have a significant disincentive to act to reduce a trader's position even if necessary to prevent disruption in the market.

In addition, they can only tackle problems once they arise, lack transparency and fail to deliver legal certainty for traders.

Decision-makers must act

European parliamentarians have shown their commitment to tackling food speculation through amendments to make position limits mandatory rather than voluntary, and including some provisions to make the limits more difficult to circumvent. Specifically, the text approved by MEPs in October 2012:

- Ensures that limits would be **set at EU level** by the European regulator ESMA. This would prevent member states competing in a race-to-the-bottom to set the weakest limits in order to win business from other countries.
- Requires **limits to be used to prevent prices being distorted** by activities like excessive speculation.
- Specifies that limits should **apply both to contracts that are settled with a physical delivery** of the commodity in question, **and contracts that are settled in cash** (which are more often used by speculative traders).
- **Avoids including an exemption for "treasury financing activity"** which could be exploited by speculators to evade the limits.

These strengths must be built on in the final compromise in order to tackle remaining weaknesses in the text. Without these changes, the opportunity to effectively regulate commodity speculation will have been missed. Specifically, MEPs must support changes to:

- Ensure that limits can be applied to **all contracts**, not just those traded on exchanges. The text agreed by the Council of Ministers would allow limits to apply to all contracts whether traded on an exchange or 'over the counter' (OTC). This must be clarified in the final text. Widespread use of opaque bilaterally-traded OTC derivative contracts is widely recognised as a contributor to the 2008 financial crisis, and in 2009 the G20 agreed, as far as possible, to bring trading of these contracts onto regulated exchanges. Position limits must apply to all contracts, including any traded outside of exchanges, otherwise speculators will have an incentive to increase their use of OTC contracts.
- Ensure that the limits will **apply to all months** of commodity derivative contracts, not just a short period before they expire. The current text is unclear about this. Most speculators don't hold their contracts until the expiry date, since they do not want to take physical delivery of the commodity, but instead trade them for profit before this date. If position limits only apply at or close to the expiry date, a large part of the speculation that currently occurs could continue.
- **Remove the requirement for limits to be used to "support liquidity"**. The text agreed by the Council of Ministers suggests that this wording should be deleted. Limits are not a tool for supporting liquidity, and the retention of this clause could lead to limits being set too wide, reducing their effectiveness.

What MEPs can do

Please contact Markus Ferber, rapporteur for the MiFID review, and the rapporteur for your party group and ask them to support a compromise text which:

- Clarifies that limits will apply to OTC as well as exchange-traded contracts;
- Specifies that limits will apply to all months of commodity contracts, not just the period immediately prior to expiry;
- Deletes the provision for limits to "support liquidity".

In addition, they should defend the amendments already agreed by MEPs to:

- Ensure that the limits are set at EU rather than national level;
- Specify that the limits should be used to prevent prices being distorted by activities such as excessive speculation;
- Require that limits are set for cash- and physically-settled contacts alike;
- Avoid including an exemption for "treasury financing activities".

For more information, please contact Christine Haigh | christine.haigh@wdm.org.uk | +44 20 7820 4900
More detailed information and reports are available at www.wdm.org.uk/food

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