

## Tackling the Challenges of Commodity Markets and Raw Materials

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On 2 February 2011, the European Commission (EC) published a communication on the volatility in commodity prices and the fluctuating price of raw materials. The communication presents an overview of work that has been done to improve the regulation, integrity and transparency of financial markets.

Due to the wide-reaching effect the rising prices of commodities and raw materials have had within the European Union (EU), including with respect to financial markets and relations with countries outside the EU, the EC continues to emphasise the importance of stabilising these prices. European Commissioner Michel Barnier, part of the EC delegation that presented the communication to the European Parliament, said that "agricultural products are no longer foodstuffs but have also become financial assets." The increased connectedness between all of these areas means that developments in financial markets can trigger investment or hedging decisions in relation to the underlying physical commodities.

### Increasing Prices and Volatility

In the communication, the EC states what it believes to be the primary reason for the increasing prices seen in all major commodity markets, namely the underlying change in global supply and demand fundamentals. In particular, strong economic growth and rapid industrialisation and urbanisation in countries such as China, India and Brazil between 2002 and 2008 has resulted in a surge in demand for raw materials. Commodity markets also were affected by the increased availability of finance. To illustrate, investment in commodities markets increased from EUR13 billion in 2003 to between EUR170 billion and EUR205 billion in 2008.

The EC is not of the view that volatile commodity prices are caused by derivative speculation. Indeed, the communication states that, even though there is a strong correlation between positions on derivative markets and spot prices, it is nonetheless difficult to fully appreciate "the impact of movements in the derivative markets on the volatility of the underlying physical markets." Rather, it is only through increased transparency and reporting that such a correlation would be conclusive, and it would be possible to identify which way the causation flows.

### **Ongoing Reform of Financial Markets**

The communication is part of the EC's ongoing initiatives to increase the integrity and transparency of the commodity derivatives market, in line with the G20's principles. Other proposals to strengthen the financial market include the following:

Regulation of over-the-counter (OTC) derivatives trading

<http://www.mwe.com/info/pubs/EU%20Financial%20Reform.pdf>.

### **Review of the Market Abuse Directive**

Review of the Markets in Financial Instruments Directive

[http://www.mwe.com/index.cfm/fuseaction/publications.nldetail/object\\_id/7518ccd0-4d8c-4d90-952a-a9658ccac14c.cfm](http://www.mwe.com/index.cfm/fuseaction/publications.nldetail/object_id/7518ccd0-4d8c-4d90-952a-a9658ccac14c.cfm).

### **Creation of the European Securities Markets Authority (ESMA)**

These areas of reform are in varying stages of evolution, with regulation on OTC derivatives, for example, due to come into force by the end of 2012.

The EC acknowledges in the communication that there must be a better understanding of the interaction between the physical and financial commodities markets. Such understanding would promote further improvements in the transparency and accessibility of information in both markets, and help prevent abusive practices through reporting to the relevant national and EU-wide regulators and institutions, one such regulator being the newly-formed ESMA.

The communication reinforces strategy with regard to the European Raw Materials Initiative 2008 (RMI). The RMI is based on three pillars: ensuring a level playing field in access to resources in non-EU countries, fostering sustainable supply of raw materials from European sources, and boosting resource efficiency and promoting recycling. The EC acknowledges that, although significant progress has been made in implementing the three pillars, further improvements are nonetheless necessary. The EC intends to consider the full implementation of the RMI further in a Green Paper, pursuant to a consultation process. The consultation will consider issues such as the development of a comprehensive reporting programme for issues arising out of the three pillars and encouraging governments to develop a comprehensive reform programme.

## World Economic Forum

The publication of the communication comes in the wake of the World Economic Forum (Forum) that took place at the end of January 2011 in Davos. During the Forum, French President and current chair of the G20 Nicolas Sarkozy set out his plan for curbing speculation in the commodities markets. As President Sarkozy stated, there is a need for “regulation. Not an excess...but regulation”, adding that those who buy large quantities of commodities should “commit to putting on deposit part of the financing for those commodities”. Prior to taking the helm of the G20, President Sarkozy made it clear that one of his priorities during his position as chair would be to increase regulation in the market of physical commodities (including raw agricultural products, metals, oil and gas).

The publication of the communication was delayed by almost a week as calls were made by the French to reinforce the link between speculation in financial markets and volatile commodity markets. The French insisted that the draft form of the communication was not tough enough on speculation in commodity markets. The tone of the draft communication was somewhat different to the final, released version, with the draft version suggesting little connection between derivative speculation and commodity price volatility, but with the final version suggesting that further research would be required to establish that link.

President Sarkozy’s comments at the Forum highlight a difference in view of the principal causes of the volatility in the commodities markets. Sarkozy seems to be suggesting that the cause is the lack of regulation leading to increased derivative speculation within the market. The conclusion set out in the communication is that it is down to basic supply and demand fundamentals.

## Conclusion

The conclusions of the communication are set to feed into the various areas of reform that the EC and the G20 will put in place over the next few years within the financial and physical commodity markets. The EC states that the ultimate aim “is to ensure that commodity and raw material needs are met in a way which supports wider goals for development.” Given the magnitude of potential reforms that are currently on the horizon, it is difficult to ascertain what effect the communication alone will have. However, the communication has further proven that the EC is still resolute in its efforts to focus on and reform the commodities market, particularly given the increasing recognition of the effect commodities prices have on the global financial markets.

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