Privileged access for hunger brokers

The Commission recently put forward a proposal to curb the lethal volatility in food prices by addressing speculation. But preparations of new legislation have been dominated by the financial lobby. Effective measures seem far away.

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It all sounded very promising. Before taking office, the Single Market Commissioner Michel Barnier told a cross interrogation in the European Parliament that in order to stop the 'scandalous speculation' in agricultural commodities, 'we as responsible politicians have to regulate commodity derivatives very carefully'[i]. In fact, Barnier repeated the same rhetoric once in office, stating his intention to make ambitious changes[ii].

Internationally the political space is certainly there. In the US, the Americans have taken steps to curb speculation in food prices through he Dodd-Frank Act . For once, it seemed, the financial lobby in the EU would not be able to attack proposed regulation by claiming that if they were not weakened, trades would relocate to the US. And they would not – as they did with regulation of hedge funds - be able to get the British government to mobilise the US administration to put pressure on other EU governments, the Commission and members of the European Parliament.

Despite this, when the Commission presented its proposal in October 2011 for a review of the "Markets in Financial-Instruments Directive" (MiFID in EU jargon)[iii], the level of ambition was significantly lower than US law, and will not, as it stands, do much to address the lethal volatility of agricultural commodity prices.

Why are ambitions so low? A look at the way the proposal was prepared provides some indications. It reveals a long standing problem at the Commission: that regulatory reform is mainly dealt with through interactions with the financial sector. A tradition that is always exploited effectively by the financial lobby that commands tremendous resources.

The double crisis of 2008

The battle is taking place in the framework of a revision of a directive from 2004, the Markets in Financial Instruments Directive (MiFID in EU jargon), an extensive directive that sets the rules for the behaviour of investors in a range of financial markets, mostly in 'derivatives' – which was one of the markets in the spotlight for its part in the financial crisis three years ago. This is the main reason why it has come up for review now.

But there was another crisis the very same year. Through 2006 and 2007 prices on agricultural commodities such as wheat, corn and soy began to increase, and in 2008 things shot up rapidly. During this period, the World Food Programme (UN) assesses that about 115 million more people joined the ranks of the undernourished or starving in the developing world due to high food prices during this time[iv]. Food riots took place in as many as 61 countries according to one source[v], clear proof of a serious problem. The latest estimate by the Food and Agriculture Organisation (FAO) from June 2009 was that over 1 billion people were chronically malnourished due to "global economic slowdown combined with stubbornly high food prices."[vi]

The MiFID is to be the place where the European Union addresses this challenge. But even a quick look at the preparations before the proposal was released in October, reveals that commodity prices were a marginal issue compared to the concerns of the financial sector. For instance, 'investor protection' pops up 30 times in the draft directive, whereas 'food' only appears twice[vii].

Food speculation and counter-measures – in simple terms

But why would food speculation even be a subject for a proposal on financial regulation? How can speculation on financial markets affect prices?

Basically 'food speculation' means that the prices of agricultural products (mainly grains) are affected by financial bets on their development via financial instruments called futures or swaps – both belonging to the broad category called derivatives. In the run-up to the food crisis in 2008 these 'commodity derivatives' became increasingly popular, partially because US investors were their losing appetite for the stock markets after the dot.com crisis and the imminent collapse of the US real estate market. A massive inflow of capital into the commodity derivatives market, had been spurred by the deregulation of financial markets in the US a decade back, and starting in 2003-4 things started moving fast. Prices on agricultural commodities such as wheat, corn and soy started to be to a large extent determined by speculation in financial markets.

The question for regulators, then, should be: what possible measures can counter the dangerous volatility that financial markets bring into the market in agricultural goods? One way would be to simply ban certain investors from getting involved in commodity derivatives, another to ban certain speculative products, such as the infamous 'index funds' set up by banks across the US and Europe to channel investments into bets on prices of a basket of commodities.

The most widely debated issue at the moment, however, is an approach adopted in the US in July 2010, known as position limits. With position limits ceilings on the investments of individual investors are fixed in order to limit the amount of money in the commodity derivatives markets. It's not a new idea. It was implemented in the 30s in the US and functioned for decades until major loopholes were opened up in the legislation in the 90s, leaving agricultural commodity markets completely open to financial speculators with no link to the real economy of food.

Now, the US is taking a step back and is reinstating position limits as a key regulatory tool. With the Dodd-Frank Act, adopted in July 2010, loopholes are being closed. Since then a big question has been whether the EU would follow the US.

Limits… or something like that

With the Commissioner's strong rhetoric and several resolutions in the European Parliament demanding effective action, you might think that the least the Commission could do would be to match the US initiative. But the draft legislation of the Commission is considerably weaker than the US approach in many ways. First and foremost, while the Commission does propose that member states are asked to adopt position limits, the proposal explicitly recognizes the model used in the UK, called 'position management', as a legitimate substitute[viii]. This is bad news , according to the World Development Movement, a UK development NGO that has campaigned on food speculation for years:

"The Financial Services Authority and the UK government haven't presented any evidence to back their claim that position management has worked, and there is clear evidence to the contrary. Under the UK's position management system, in July 2010 the hedge fund Armajaro nearly cornered the entire European cocoa market through the London exchange[ix] and in May 2011 Frontier Agriculture (linked to giant grain company Cargill) bought all the futures contracts on the London feed wheat market[x]. These kinds of events could not have happened with clear and effective rules of position limits," WDM told CEO[xi]

When member states are at liberty to pick a soft regulatory approach, there's a danger it will undermine the overall attempt to curb the inflow of investments into the market. Particularly when the UK and its strong financial sector are involved. Ironically, the Commission is all too aware of this. In a key document about the preparations of the legislative proposals, it's stated that if some member states apply 'hard position limits' and the UK sticks to its system, it "could give rise to regulatory arbitrage and/or unlevel playing field concerns, especially when contracts on the same commodity are traded on multiple exchanges."[xii] In other words, traders could simply seek the least regulated spot, ie. the UK, and thereby undermine the effort to curb speculation.

For what purpose

There are other weaknesses in the proposal. While the objective of position limits in US legislation is relatively clearly defined, the corresponding EU proposal is vague. In the US, position limits are to address 'sudden or unreasonable fluctuations or unwarranted changes in the price'[xiii] and 'diminish, eliminate, or prevent excessive speculation'[xiv]. In the EU, however, positions limits are to ensure liquidity, avoid manipulation and ensure 'orderly markets' or 'orderly pricing'. Such language is much less clear, and does not provide the kind of guidelines that will push financial authorities to restrict speculation to a level that would keep dangerous volatility at bay. There is – for instance – no real definition of 'orderly markets' included in the proposal. And in any case, for the financial sector, 'orderly' could mean merely the absence of systemic risk, in other words a threat to the financial system.

This lack of clear objectives means that there is also no clear indication as to where –how high - position limits should be set. And the fact that ‘liquidity’ tops the list of objectives, could suggest that the volume of trade should not be affected. Hardly a recipe for effective limits.

Lobbying power and old Commission habits

In sum, there’s a long way from Commissioner Barnier’s bold statements on the necessity to regulate these markets, to the draft legislation presented in October. How, then, can it be that the Commission has opted for such a weak proposal? There’s more than a single explanation, and there’s little doubt that early opposition to position limits voiced by the UK is important. But two other phenomena are key.

First, the financial lobby in Brussels has considerable means at its disposal. With an estimated 700 lobbyists in Brussels[xv], the ability to strike when needed is unquestionable.

Secondly, they have thrived on a deep-rooted mentality within the Single Market Commissioner's office and among civil servants at the Directorate General, that when it comes to financial regulation, the relevant advisors are the financial corporations themselves. “If you’re looking for financial advice, you don’t ask a baker”, as a civil servant said when confronted by evidence of corporate capture of the legislative process two years ago[xvi].

For once, it would actually have made sense to ask a baker, or at least a variety of organisations and companies rooted in the trade with agricultural products or in production. Farmers perhaps? But old habits don’t change easily. Not even a financial crisis or two has changed the picture – and the food crisis certainly hasn’t. That becomes obvious from a go-through of the most important elements of the preparatory process.

Advisory groups on derivatives

Whenever the Commission embarks on an ambitious proposal, it consults with one or more advisory groups or ‘expert groups’. An advisory group would typically include representatives from the industries concerned, member states authorities and maybe a few academics. These groups have been widely criticised for their unbalanced composition in the favour of industry and big business in general, not least for the financial expert groups which have historically been completely dominated by representatives of financial corporations. The groups on derivatives in recent times speak their own language.

Reform of derivatives regulation has been on the table since the financial crisis broke in 2008. Compared to the US, the EU has been remarkably slow, with the first major reform on derivatives passed only recently. Since autumn 2008, the Commission has been in dialogue with the financial industry concerning derivatives regulation, and has carried out a large number of consultations. Until late 2009, a lot of debates between the Commission and the financial industry took place in the framework of these groups. By then a ‘derivatives expert group’ was in operation – completely dominated by derivatives lobby association ISDA (the International Swaps and Derivatives Association) and its members- large financial corporations, including European banks such as

Deutsche Bank, Barclays, and US banks Goldman Sachs, JPMorgan and Morgan Stanley, all famous for their involvement in food speculation[xvii].

The derivatives advisory group was closed down, but was soon to followed by another expert group: the Expert Group on Market Infrastructures, which worked throughout 2010 to assess financial markets in the EU and the effect of several directives, including MiFID. This too was completely dominated by representatives of financial corporations. Its role in drafting the proposal is unclear, but the Commission clearly made its assessment of the impact of existing legislation based on the discussions in the group[xviii].

Expertise on commodity derivatives

The big question here is what kind of advisors were selected on new legislative proposals on food speculation. Has the Commission navigated its way through this part of the MiFID-reform without special hand-picked advisors? Without expert groups?

In fact the Commission has carried out six ‘workshops’, each one on different aspects of the MiFID review, most of which were only attended by financial corporations and lobby associations[xix]. Of the six, one was on commodities, and had a slightly different composition – but only slightly. Here, the 13 persons workshop was rather dominated by exchanges and energy brokers and traders – adding their hostility to position limits to that of ISDA[xx].

However, if the stakeholders with direct involvement in commodities trade had been asked, a different picture would have emerged. The European Flour Millers for example were very outspoken in favour of position limits , while the CIAA (now FoodDrinkEurope) was ambivalent, but clearly worried about volatility.

But these voices were apparently drowned out. In its conclusion, Commission staff wrote: “Most stakeholders were opposed to enabling regulators to set position limits, as this would harm the markets.”[xxi]

Written consultation

The dominance of the financial sector on the MiFID review became equally apparent in the Commission’s public consultation. Anyone can send a contribution, but obviously some have been attracted more than others – and some have more capacity and feel of the issue. Of the slightly more than 320 private contributors, about 85 per cent were from the financial sector - only four were directly linked to processing or trading food.[xxii]

To the extent that the contributions from the financial sector addressed position limits, they were firmly against. Goldman Sachs, though, surprisingly supported limits, only to change its position a week later at a meeting with the Commission. “They oppose limits in financial markets…the CFTC model (US) ..is flawed so should not be used as a model”, the minutes from the meeting reads[xxiii].

When you look at the four contributors from the food sector, the picture is much more mixed. Whereas the grain traders from FEDIOL and FEFAC rejected –with identical wording– the need for limits, CIAA was ambiguous – complaining about volatility but without a clear response to the question of position limits. Many food producers, including big corporations like Unilever and Nestlé have aired deep concern over food speculation, a concern reflected here via CIAA. The European Flour Millers for their part, were firmly in favour of limits. In other words, while divided, the sector takes position limits much more seriously as an option than the financial sector. But as a result of the dominance of the financial sector within the overall consultation, position limits were clearly not popular with the majority of respondents.

CESR advice

There is one written response that carries particular weight, and which deserves attention. The advice of the EU body of financial authorities, CESR (now called ESMA), has provided a small avalanche of advice on the MiFID review over the past couple of years, including on position limits. The overall conclusion is rather negative. In its response to the Commission on the issue, the CESR/ESMA leans towards 'position management' rather than position limits: "The Commission should in CESR's view focus on analysing whether exchanges/regulators have sufficiently extensive set of powers to manage positions across the entire life of commodity derivatives market contract curves setting up a harmonised set of powers for exchanges/regulators in European legislation and considering whether there is a need for further harmonisation in the way those powers are actually implemented across EU commodity derivatives markets."[xxiv] With this emphasis on 'position management' the CESR/ESMA puts its weight behind the UK approach.

CESR developed its feedback in a dialogue with 'stakeholders' at a workshop, which in the world of CESR means, once more, the representatives of the major players on financial markets[xxv]. There is nothing to suggest that CESR/ESMA has brought in specialists, consumer or producers to analyse or discuss the effects of commodity derivatives on prices. It seems to have been analysed as a purely financial market – and not as the hybrid market it actually is.

Knock-on-the-door lobbying

On top of this comes the classical knock-on-door lobbying. Financial industry lobbying on commodity derivatives, including on the MiFID review, started a long time ago. As early as 2006 three lobby associations started meeting on a regular basis with the Commission to stave off regulation of commodity derivatives and of the companies involved in the trade. They were ISDA (see above), the Futures and Options Association (FOA)[xxvi] and the Energy Commodities Traders Group (later called EFET). These three formed an alliance known as the 'Commodity Derivatives Working Group'[xxvii]. This group was to work together throughout, and ensured a close alliance between the financial community and the energy sector – traders and producers alike. Their agenda was ambitious from the outset - to avoid capital requirements for trade in commodity derivatives, avoid transparency, and to defend exemptions for traders in commodity derivatives from registration and other disciplinary requirements in the MiFID.

Meetings with Commission staff became more frequent from mid-2008 onwards, with ISDA primarily in a coordinating role – for instance by making sure that major financial players, such as member Deutsche Bank, Goldman Sachs, BNP Paribas and Societé Generale, appeared at the same meetings[xxviii]. These meetings were – among other things – used to deny the significance of speculation in the price bubbles across markets in grains. To defend commodity derivatives, ISDA sent papers on a regular basis to deny the link to speculation. In July 2008, it stated that “this is investment that is responding to market conditions, however with a very limited impact in terms of ‘amplification’ of price”. Less than a year later, in view of a dramatic collapse in prices, ISDA claimed that “sharp falls in commodity prices have been driven by a significant decline in global demand”. A statement made at a time when prices had started a sharp movement upwards again.

While the claim that dramatic price bubbles are merely an expression of supply and demand were not necessarily accepted at face value by the Commission, there is little evidence to suggest that anything was done to ensure a proper debate. For instance, in the long list of literature in the impact assessment on MiFID, there is practically nothing from the substantial literature on the effect of speculation[xxix].

Agricultural corporations

In fact, the whole agricultural scene has played a very marginal role. The financial sector has been allowed to dominate the debate on the MiFID review, including on commodity derivatives. What would all this sound like if the debate was not among different sections of the financial community, but among players in the real economy of agriculture? It would certainly be different. As noted above, on the few occasions where companies or associations with a direct interest in production or the sale of agricultural commodities have appeared in the debate, different viewpoints from those of the financial industry have been aired. But by and large, these voices were drowned by the massive presence of the financial industry.

There are some exceptions to the rule. Some corporations in agri-business have interests of their own to guard in the financial markets. They either manage to benefit from speculation, or have developed methods of their own to turn financial markets to their advantage. This goes for the association of traders in grain and oilseeds, such as the associations Coceral and Fediol, and giant grain companies like Cargill (see example on Frontier Agriculture above). At bilateral meetings with the Commission, they have tried to make sure that their particular interests were heard, though, their standing seems to be marginal[xxx].

Farmers and consumers

As for those voices in agriculture that have voiced deep concern in public over the role of financial markets, they are almost absent from the Commission's key documents, from the key meetings, and from other stages of the preparation of the proposed legislation, even though the Commission wouldn’t have had to look far to find them. That goes for small farmers associations and consumers. But actually, only a few small steps have to be taken to discover that the issue is viewed in a very different way by for instance, the association of large conventional farmers, COPA-COGECA, whose president said in January 2011:

"When speculation runs away with itself, it results in excessive market volatility. It leaves both consumers and farmers at the mercy of speculators. This kind of speculation has to be restricted to ensure that prices reflect economic fundamentals and not the excesses of speculators. It means limiting the extremes characteristic of most financial markets. I don't claim to have the solution but more transparency and information would certainly help. Maybe also by limiting the size of position or close markets when prices exceed a certain range. There must also be more effective controls on outright manipulation of the market".[xxxi]

This viewpoint was to be repeated at a meeting in April 2011 with Commission staff on the MiFID review. At this meeting, dominated by agribusiness corporations, the big farmers were quoted briefly with no detail: "COPA-COGECA was quite vocal on the disturbing role played by excessive speculation"[xxxii]. At the meeting, as well as in the big picture, statements like this have been rare in the preparation of the MiFID proposals.

The clash between the few voices with no stake in financial markets, but who feel the consequences, would surely be even starker, if consumers, small farmers or organisations with a commitment to the poor of the developing world, had been taken seriously as partners in this debate. But instead of revising old habits in view of the specificities of agricultural markets in view of the emerging financialisation and the threats inherent in this development, the Commission has once again opted for a myopic approach. A victory for the financial sector.

Conclusion

Speculation in agricultural commodities is a question of life and death. And it's a question that obviously cannot be left to the financial sector that is causing the problems. But in Brussels, they have once again displayed the capacity to set the terms of the debate. For its part, the Commission has not shown any willingness to set a different stage. They have stuck to traditional procedures, and have consulted widely with the financial industry, side- lining agriculture, consumers and other voices with a feel for the real problems in markets for agricultural products. The cross over between financial markets and markets in agricultural goods is a pretty unique phenomenon, and it has proved extremely dangerous. Even so, looking at the procedures of the Commission, the matter has mainly been looked at from the angle of the financial community. And with the massive resources that the financial lobby can put into any matter in their interest, such opportunities will always be exploited to the maximum. Even when mainstream farmers organisations and big multinational food corporations air a very different opinion, they're not able to rebut the financial lobby.

This is not to say that the Commission has accepted every demand from the financial sector. But it has produced a proposal that does not live up to the challenge posed by the dramatic consequences of extreme price volatility. Hopefully the debate that will now follow, and that will result in new regulation, will be different.

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[i] Hearing of Michel Barnier, European Parliament, 13. January 2010.
[ii] Eg. during a conference organised by the Commission, 20. September 2010.
[iii] The proposal for a new MiFID (directive), proposal for a regulation (MiFIR), as well as links to consultation documents etc., can be viewed here: http://ec.europa.eu/internal_market/securities/isd/mifid_en.htm
[iv] World Food Programme statistics, quoted from World Development Movement;"The Great Hunger Lottery", 2010, page 5, http://www.wdm.org.uk/sites/default/files/hunger%20lottery%20report_6.10.pdf
[v] Joachim von Braun; "Food and financial crises- Implications for the poor", Food policy report, IFPRI, December 2006, page 6, http://www.ifpri.org/sites/default/files/pubs/pubs/fpr/pr20.pdf
[vi] FAO; "One sixth of humanity undernourished- more than ever before", 2009. http://www.

fao.org/news/story/en/item/20568/icode/ Quoted from World Development Movement; “The Great Hunger Lottery”, 2010.

[vii] COM (2011) 656 final, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0656:FIN:EN:PDF

[viii] COM (2011) 656 final, article 59, page 126, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0656:FIN:EN:PDF

[ix] See for instance Financial Times, 16. July 2010, http://www.ft.com/intl/cms/s/0/e50feefc-9120-11df-b297-00144feab49a.html

[x] See the Telegraph, 30. July 2011, http://www.telegraph.co.uk/finance/commodities/8672046/Wheat-buy-up-sparks-price-manipulation-fears.html

[xi] Murray Worthy, World Development Movement, to the author, November 2011. Both Armajaro and Frontier Agriculture are UK companies.

[xii] European Commission, Impact assessment of MiFID, SEC (2011) 1226 final, October 2011, page 110.

[xiii] A stated objective in US legislation since the adoption of the Commodity Exhange Act in 1936.

[xiv] Dodd Frank Wall Street Consumer Protection Act, page 1723, http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf

[xv] Assessment by FinanceWatch.

[xvi] EUObserver.com, 5. November 2009, http://euobserver.com/19/28947

[xvii] Corporate Europe Observatory, “Financial Warmongers”, April 2010. ISDA’s list of members is pretty much a who’s who of the financial sector; http://www.isda.org/membership/isdamemberslist.pdf

[xviii] The report of the EGMI and agendas of meetings can be viewed here; http://ec.europa.eu/internal_market/financial-markets/clearing/egmi_en.htm

[xix] European Commission, Impact assessment of MiFID, SEC (2011) 1226 final, October 2011, page 279 ff.

[xx] In the ’Impact assessment’ of MiFID, a number of participants at the workshop on commodities are mentioned, but at least one participant is not listed, ISDA – the biggest derivatives lobby organisation globally. See next footnote.

[xxi] European Commission, minutes of workshop on commodity derivatives, April 2011.

[xxii]The public contributions to the consultation can be viewed here; http://ec.europa.eu/internal_market/consultations/2010/mifid_en.htm

[xxiii] Contribution of Goldman Sachs to the consultation (quote from page 9): https://circabc.europa.eu/d/d/workspace/SpacesStore/2f181f5e-3049-4344-97e4-7a853bc5a699/Goldman%20Sachs%20Int.pdf . Excerpt from minutes of meeting, DG MARKT, 9. February 2011.

[xxiv] CESR/10-1254, October 2010, http://www.mfsa.com.mt/files/LegislationRegulation/regulation/securities/MiFID/10_1254.pdf

[xxv] Ibid, page 26. See for instance the membership of the ‘Securities and Markets Stakeholder Group”at the ESMA, http://www.esma.europa.eu/template.php?page=groups&id=64&keymore=1&BoxId=1 or the MiFID consultative group, http://www.esma.europa.eu/template.php?page=contenu_groups&id=53&keymore=1&BoxId=2 (in function until April 2010). Also, at a meeting with DG MARKT, giant grain sales company complains that ‘ESMA stakeholder groups did not seem to provide for involvement of end users such as themselves’, according to minutes of meetings, 15. December 2010.

[xxvi] Members of FOA are most often members of ISDA too. This goes for banks like Goldman Sachs, Deutsche Bank, Barclays Capital, JP Morgan and Morgan Stanley. List of members: http://www.foa.co.uk/Default.aspx?pageid={69197089-8e15-482a-8763-1b35bdf5a645}

[xxvii] Documents from the European Commission on communication with the Commodity Derivative Working Group, 2005-2009.

[xxviii] Emails from DG MARKT to ISDA and viceversa, January 2010.

[xxix] There is little more than a document of the Commission; Commission Staff working document (SEC(2009) 1447) Agricultural commodity derivatives – the way ahead, 28 October 2009

[xxx] Minutes of meetings with Cargill (DG MARKT), 20.October 2010, e-mail correspondence Cargill-DG MARKT, May and June 2010, and minutes of meeting DGMARKT-Coceral & Fediol, 29.april 2011.

[xxxi] Press release, COPA-COGECA, 11. January 2011.

[xxxii] European Commission, minutes of meeting with agricultural producers and traders, 29. April 2011.