

Commodity Storage and Delivery Infrastructures: Good or Sound Practices

Consultation Report



IOICU-IOSCO

**The Board
OF THE
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS**

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Foreword

The Board of the International Organization of Securities Commissions (IOSCO) has published this Consultation Report with the aim of outlining guidance in the form of Good or Sound Practices to assist relevant storage infrastructures and their oversight bodies to identify and address issues that could affect commodity derivatives' pricing and in turn affect market integrity and efficiency.

Comments may be submitted by one of the three following methods **on or before August 29th**. To help us process and review your comments more efficiently, please use only one method.

Important: All comments will be made available publicly, unless anonymity is specifically requested. Comments will be converted to PDF format and posted on the IOSCO website. Personal identifying information will not be edited from submissions.

1. Email

- Send comments to consultation-05-2018@iosco.org.
- The subject line of your message must indicate '*Consultation Report on Commodity Storage and Delivery Infrastructures: Good or Sound Practices*'.
- If you attach a document, indicate the software used (e.g., WordPerfect, Microsoft WORD, ASCII text, etc) to create the attachment.
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Send 3 copies of your paper comment letter to:

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Your comment letter should indicate prominently that it is a "*Public Comment on The Consultation Report on Commodity Storage and Delivery Infrastructures: Good or Sound Practices*".

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Chapter 1 – Introduction

This report builds on the findings that are set out in the report “*The Impact of Storage and Delivery Infrastructure on Derivatives Market Pricing*” (Storage Report), which was published by IOSCO on May 9, 2016.

This follow-up project provides guidance to relevant storage infrastructures (RSI) and their relevant oversight bodies (ROB) in the form of Good or Sound Practices to assist those entities to identify and address issues that could affect commodity derivatives’ pricing and in turn affect market integrity and efficiency.

IOSCO encourages the adoption of the Good or Sound Practices that are set out in this document, as appropriate to their role and activities, by all RSI, ROB and financial regulators in the jurisdictions of IOSCO members. IOSCO believes that the implementation of these Practices will lead to a more transparent and robust environment for the physical storage and delivery of commodities which will produce benefits for all commodity market participants.

As is appropriate for Good or Sound Practices, a range of measures are included within this document. Not all of the Practices described may be relevant to all market participants. It is for market participants to determine the applicability of any particular Practice and to apply it as their circumstances require.

In recognition of the differences in regulatory frameworks and the purview of IOSCO member regulators, RSIs and ROBs, the Good or Sound Practices in this report are directed in a number of ways. By way of example, a Good or Sound Practice may include the wording “should”, “could” or “may” depending on, respectively, whether there is a reasonable expectation that an RSI, ROB or financial regulator expects such measures to be in effect; the Practice is desirable to meet the intended goal or mitigate the identified risk; or whilst optional, the Practice identified represents a positive standard which may be achieved and demonstrated by the RSI, ROB or financial regulator.

Chapter 2 – Executive Summary

This document sets out a number of issues which may apply to storage infrastructures and possible actions to mitigate them in the form of ‘Good or Sound Practices on Storage and Delivery Infrastructure’.

The Storage Report noted that there is a wide range of practices related to the storage of physical commodities and storage infrastructure operations, which vary by type of commodity, trading venue, and jurisdiction. Disparities were found to varying degrees in practices related to the oversight, governance, operations and controls of storage infrastructures, and in the transparency afforded by those practices. These practices have the potential, if not addressed by appropriate policies and procedures, to affect derivatives pricing. These were categorised into five broad areas with the potential for reform: Oversight, Transparency, Conflicts of Interest, Fees and Incentives and Operations.

The reason that certain key elements should be present in the regulatory structure for storage and warehousing is that, unlike in the cash market, futures transactions are anonymous matches between buyer and seller (i.e., market participants do not choose their counterparties). In order to achieve some level of confidence in the integrity of the market throughout the stages of execution, clearing and settlement, both buyer and seller should understand – and be committed to – transacting according to the terms and conditions for the commodity derivative product and the execution of the delivery and load-out.

In addition, good or sound practices are useful because the regulation of storage and warehousing is an on-going and evolving process. As derivatives markets innovate, change and adapt to keep pace with cash markets, storage and warehousing practices and the regulation thereof also needs to evolve. In the process of developing good or sound practices that address, where appropriate, this variability amongst RSIs, key elements are further identified that are crucial to promoting market integrity regardless of trading venue or jurisdiction.

Given that the commercial practices and legal frameworks for the cash market in the underlying commodity and the nature of the commodity or the commodity class largely dictate the storage and warehousing practices for the commodity derivative contract, it is not expected that storage and warehousing practices will become uniform across jurisdictions, trading venues, or commodity derivative contracts. However, there are certain elements of good or sound storage and warehousing regulatory structure that are uniform, regardless of the responsible entity and manner in which those elements are executed.

In the document below, each of these identified areas is considered, and a number of potential good or sound practices that could address these issues are set out, which may be applied as appropriate to the jurisdiction, regulatory arrangements and operational activities of an RSI. The overarching theme of the potential good or sound practices is to create a framework that incentivises the market towards best practice and self-correction, rather than one that takes a prescriptive approach in prohibiting certain behaviours or requiring new actions.

Good or sound practices can be broken up into three categories:

- a. preventative practices that seek to establish good governance and dispute resolution procedures in an effort to avoid issues;
- b. monitoring practices that seek to address issues as they arise in order to mitigate deleterious effects; and
- c. punitive practices which address, through resolution, behaviours after the fact.

The good or sound practices set out within the document include examples of all three types.

Chapter 3 – Terminology

In this document, various market-specific terms are used. These should be read in a purposive manner; IOSCO has not sought to be prescriptive in the language used, nor to capture exclusively all market practices. Amongst the more specific terms used are:

- a. RSI. Used to describe any physical infrastructure used to store or transfer commodities as part of the physical delivery process related to a commodity derivative contract, whether the commodities are held for a short or long term period. Depending on the nature of the commodity this may include warehouses, grain elevators, sheds, silos, tanks, pipelines, marine vessels, open storage areas, vaults or other forms as appropriate to a deliverable commodity.
- b. ROB. Used to describe a market authority, such as a trading venue, a central counterparty (CCP), a self-regulatory organisation or a statutory regulator that oversees an RSI. This oversight can be through direct governance, at arm's length or indirectly. Where appropriate, an ROB exercising authority over market participants subject to financial regulation (rather than oversight of physical market activities) the term "financial regulator" is explicitly used. Where appropriate, these good or sound practices also indicate whether certain measures are better exercised by financial regulators or by other ROB's.
- c. Fees. Used to describe the charges made by an RSI owner for the storage of commodities within that RSI. This document does not distinguish, except where specifically referred to, whether fees are fixed rate for either quantity or period, variable in amount, proportional to either quantity or period, or some combination thereof. Fees may also describe the charges for additional services provided by RSIs, such as grading of the commodity's quality, or insurance of the commodity for the period it is within the RSI.
- d. Rules. Used to describe the regulatory framework for the operation of trading venues and of central counterparties (CCPs), for the establishment of product terms and conditions and for the oversight of RSIs which are part of the delivery mechanism for the commodity derivative contracts which are traded on those venues or cleared by those CCPs. The rules may be in the form of formalised rules as set out in a rulebook, or as principles, best practices, guidance or contractual conditions and arrangements. The rules may be those of the trading venue for the commodity derivative contracts, the CCP for the clearing, margining and settlement of those contracts, the relevant national regulators who oversee the trading venue, the laws of the national government or of a sub-national (e.g. state, provincial) government where the relevant trading venue, CCP or RSI is located.

Chapter 4 – Oversight

Trading venues or CCPs should suggest that RSI's linked to their products or contracts adhere to the good or sound practices. Market participants and users of RSI will, where these choices are available, generally tend to RSI's where best practices are followed rather than those viewed as having lesser standards. An appropriate level of oversight involves the establishment of a certain responsibility to the users of a market to ensure that an acceptable level of service is available.

Trading venues or CCPs could, for instance, depend on users of the “on-exchange” commodity derivatives to report complaints or concerns about an RSI's adherence to good or sound practices. Trading venues or CCPs can utilise a complaints mechanism to monitor issues, and work with RSIs to address complaints.

The Storage Report noted that financial regulators generally do not have direct authority over RSIs. In most cases, financial regulators directly regulate trading venues and CCPs, which, in turn, are responsible for creating the delivery terms and procedures for commodity derivative contracts, as well as establishing the framework that governs the on-boarding and oversight of RSIs participating in the storage and delivery processes and ensuring that they comply with trading venue, CCP, and all other applicable rules regarding storage and delivery.

Foremost of preventative practices, the trading venue, CCP or other ROB should establish clear jurisdiction over RSIs, including minimum standards for participation and approval in their rules. Clear expectations provide confidence to market participants and promote a level playing field among RSIs that are interested and eligible for participation in the delivery process. Second, the ROB should clearly identify a process for dispute resolution between and among market participants and the RSI, including restitution.

Depending on the jurisdiction, derivative contract terms and conditions, as well as relevant trading, clearing or settlement rules would be binding, either directly or indirectly, on trading venue or CCP members or on market participants and infrastructure users and may be subject to review or approval by the financial regulator. The financial regulator may be able to engage with the trading venue or CCP on its compliance with, and enforcement of, those terms, conditions and rules on an initial and on-going basis.

In considering the regulatory framework which applies to RSIs, the Storage Report noted variability in practices exercised by trading venues or CCPs in the oversight of RSIs. There was also a variation in the powers which trading venues had to require good behaviours by RSIs and to act against harmful behaviours.

ROBs may require certain rules to prevent behaviours by RSI operators that could negatively impact the price discovery process, i.e., impose specific requirements for warehouse operators or other responsible parties as designated by the RSI, only allow participation by RSIs that agree to be subject to the jurisdiction of the ROB, consent to arbitration, adhere to certain financial soundness requirements, information transparency and/or accountability measures. Such requirements should promote efficient delivery process and enable the trading venue to adequately monitor for risks.

Financial regulators may also require that trading venues hold certain powers to resolve any negative behaviour in a timely fashion, such as taking emergency action itself or by compelling a RSI to act. Finally, financial regulators may require that trading venues or CCPs have the ability to sanction RSIs for actions that compromise market integrity.

These requirements should be formalised in the rules of the trading venue or CCP, in the application for participation in the delivery process or included with the contract or any other agreement that the RSI enters into to formally codify the powers over the activities and behaviours of RSIs. ROBs may also require trading venues or CCPs to have established governance procedures that ensure interactions with RSIs are conducted impartially.

As financial regulators have the capability to oversee and, if necessary, to sanction or take other measures against trading venues to ensure the integrity of trading in a commodity derivative contract, ROBs may also have the capability to enforce suitable standards of behaviour on trading venues to ensure that the RSIs and the trading venue's delivery processes, which is used for the settlement of commodity derivative contracts, does not cause market disruption.

As part of the oversight of trading venues, those venues may be required to provide direct or indirect access or to make information available upon demand to financial regulators demonstrating that the relevant RSIs, and the parties to the delivery process, are complying with the trading venue's requirements and not causing market disruptions. One way in which this could be done, for example, to ensure the financial stability and continued operation of RSIs; the trading venues or CCPs which are their ROBs may require RSIs or RSI operators to submit as part of an on-boarding process, or provide on a periodic basis, a statement showing that the RSI has a minimum net worth, which could be evidenced by financial statements, in an audited form where this is applicable.

ROBs may require that RSIs appoint and clearly mandate a suitable person at an appropriate level within the entity or group with responsibility for adherence to the applicable rules established by ROBs or other relevant third parties such as a physical market regulator, or governmental organisation.

RSIs could adopt the broad principle of "Know Your Customer" with the purpose of ensuring those entities who are the depositors of commodities are adequately identified for the operational and legal efficiency of the storage activity, and in particular assisting the resolution of any dispute.

The Storage Report also noted that, in most cases, ROBs have direct authority over RSIs for investigations and enforcement actions related to the ROBs' relevant statutory oversight. While these authorities are useful in addressing manipulative behaviour after-the-fact, ROBs have very limited ability to detect and address emerging problems that can affect derivatives pricing. Resolving questions of regulatory jurisdiction and applicable powers can also present obstacles and delays in addressing emerging problems.

In jurisdictions where the legal framework permits it, legislative bodies could consider granting express direct oversight of RSIs to financial regulators. As a result, such

regulators would be permitted to devise and implement regulatory regimes for the fair and efficient functioning of RSIs. In the case of many financial regulators, this would mean extending the boundary or perimeter of financial regulation to include these activities which relate to physical commodities. Financial regulators would also have to acquire the necessary resources and skills to directly supervise the many and varied types of storage infrastructures. This would, therefore, represent a significant extension of the role of financial regulators and is beyond the remit of Good or Sound Practices.

A further aspect of oversight which is relevant to RSIs is extra-territoriality. A point of uncertainty that was expressed by market participants, and which was evident from the descriptions of the existing rules of trading venues that were described to IOSCO, was around the territorial application and regulatory jurisdiction over the RSIs which are associated with trading venues.

This issue is particularly significant when a derivatives contract permits the delivery at or through an RSI that is located in a territory other than the one in which the trading venue or CCP is located, and/or the contract is listed for trading. Without the RSI consenting through a legal, regulatory or contractual arrangement to the jurisdiction of the trading venue, there is a lack of clarity over the application of the rules of the trading venue or CCP and, by extension, its (the trading venue's or CCP's) financial regulator, over extra-territorial RSIs. This lack of clarity can delay or interfere with the trading venue, CCP or the ROB's ability to take measures to address issues arising from contracts which have deliveries in extra-territorial locations.

In order to be able to swiftly resolve these issues of responsibility and jurisdiction so that appropriate actions may be taken when required, ROB's may take measures in the following ways.

In cases where financial regulators have indirect oversight of RSI, they may also make clear in their supervision of trading venues or CCPs, that in their roles as ROB's, that the financial regulators have an interest in the activity of all RSIs which provide services that are linked to derivative contracts listed in their jurisdiction, even where the RSIs at which storage or delivery takes place are located in another jurisdiction. As a result of this interest by financial regulators, ROB's may require RSIs to consent to the jurisdiction of the same financial regulator to which the trading venue on which the contract is traded is subject or to compliance with the appropriate laws or regulations of that jurisdiction.

ROB's may also consider having appropriate information sharing arrangements in place with overseas ROB's in jurisdictions in which trading venues' or CCP's RSIs are located to ensure that there is efficient and open communication and co-operation in place between those ROB's. This may extend to the use of formal Memoranda of Understanding established for these purposes. In assessing the information sharing arrangements, ROB's should consider the extent to which the overseas ROB has appropriate powers of oversight which relate to RSIs under its jurisdiction.

Chapter 5 – Transparency

A concern of both ROBs and of market participants is a perceived inability to monitor whether problems are developing in RSIs. In particular, market participants noted that there was a lack of data on the location of commodities, of movements in and out of RSIs, and of stock levels within RSIs. This is particularly relevant when knowledge of stocks can be used by market participants to assess supply of the underlying commodity and make decisions on the settlement and delivery of commodity derivatives and their underlying commodities.

One possible solution which would increase transparency is that trading venues, or their designees, regularly make public reports which may disclose, on an equal basis to all market participants, relevant data. The precise data to be published should be relevant to the type of commodity, and to the storage and delivery process of the particular trading venue. Alternatively, data may be made publicly available by trade associations, or other third parties.

Trading venues and CCPs could be expected to have a periodic audit procedure for RSIs to ensure compliance with the requirements of the rules applying to RSIs. This could cover the accuracy of the data that RSIs are submitting to the trading venue or CCP for publication, as well as the general condition of the stocks/RSIs. In assessing operational practices, the audit procedure could cover the capacity and appearance of the warehouse, business capabilities, business performance including contingency planning for cyber risks and natural disasters, accounting, delivery disputes and adjudication, the satisfaction level of members/clients, redressal of client grievances, or other factors as the trading venues may deem necessary for its review.

Trading venues should have policies and procedures in place to address any audit deficiencies.

To give transparency to market participants and third parties, the audit procedure for RSIs could be published by the trading venue.

A further approach which may be taken is for trading venues or CCPs to obtain, and to monitor, information relevant to storage and delivery of commodities within RSIs. This would enable trading venues to enter into a dialogue with RSIs and seek to resolve any issues at an earlier stage. This information would be held confidentially within the trading venue or CCP and would not be published, which mitigates a certain amount of risk of commercial harm which could arise from public disclosure.

ROBs are expected to require RSIs to use best efforts to report both planned and unplanned maintenance to market participants in such a way as to minimise potential impact on the market price of a commodity.

The Storage Report also noted that there was variation in the amount of available data and access to this data concerning RSIs' operational capacities and capabilities. For example, ROBs may not have access to, routinely collect, or make public information about an RSI such as total storage capacity, load-in and load-out rates, or aisle lengths and transport access capabilities and ROBs may have no information on disputes, defaults, delays, or penalties surrounding the delivery process. Without access to this

information, market participants' ability to make economic decisions about making or taking delivery, re-tendering the delivery instrument, or continued storage of the commodity may be compromised. Opacity of RSIs, concerns about the integrity of the delivery process, or the practices of an individual RSI may adversely affect potential market participants' views on the delivery process as a whole, diminishing participation in the derivatives marketplace and all of the risk management and price discovery benefits it provides.

In order to provide additional information to market participants, trading venues or CCPs could create or enhance the publication of information on the operational capabilities of their RSIs. This would not be in a prescriptive form across all types of trading venues and RSIs, but should be appropriate to the type of commodity and the nature of the warehousing requirements.

In addition to the publication of such information on a periodic basis, as part of their arrangement to participate in the delivery mechanism, RSIs should notify trading venues or CCPS of any changes which may affect the capability of an individual RSI to facilitate properly its role in the settlement and delivery of commodity derivatives.

ROBs should require RSIs to make timely disclosure to market participants of any changes in terms of service, particularly if that could have an impact on the market price of a commodity or of the associated commodity derivative.

In addition, trading venues should keep the ROB abreast of issues related to delivery and warehousing issues related to disputes, defaults, delays, or penalties surrounding the delivery process.

Market participants indicated that there was a lack of price transparency on the types and amounts of storage fees which are charged by RSIs. While the best practice is subjecting minimum storage rates to ROB review (i.e., as part of the commodity derivative contract terms and conditions) and making them public, IOSCO recognises that there are commercial sensitivities regarding the setting of fees and arrangements for appropriate standards and transparency of fees and charges should not harm the market for the supply of warehousing services.

Trading venues may set a requirement in their rules that RSIs must seek approval or review of RSI fees or that fees are set in a manner with is "fair, transparent and non-discriminatory" for all market participants. Where RSIs offer discounts for the storage of commodities, it should be considered whether those discounts are to be made available to all relevant market participants on similar terms, if such disclosure does not damage the competitiveness of the business of the RSI.

Trading venues could consider publishing a list of available fees and discounts which are charged by and available from RSIs.

Chapter 6 – Fees and Incentives

Even though payments for storage and warehousing occur post-trade, the storage rates and associated fees that warehouses charge for storage are an important factor in price discovery for the expiring contract, as well as for the price relationships between contract months (i.e., shape of the forward curve). Recent issues with queuing in metals and soft commodities, as well as convergence in grain markets, demonstrate the importance of good and sound practices with regard to rate setting, specifically. First and foremost, regulators and trading venues should be cognisant of the structure of the cash market, the role of storage and merchandising, and how fee rate structures - including conditions placed on privately negotiated fee arrangements - or changes to those structures may impact deliverable supply, as well as affecting the economic decision-making of market participants and therefore price formation.

General merchandising, as well as storage and other fees can be important revenue streams for warehouses and oftentimes warehouses are generating revenue from storing physical commodity both as part of their regular cash market business and also according to the terms of the derivatives market. Typically, trading venues establish and make public the maximum fees and rents that RSIs can charge for storing commodities underlying derivative contracts. This is further complicated by the fact that a particular underlying commodity may be registered, on-warrant, or certified for delivery under the terms and conditions of a derivatives contract at one point, but later be off-warrant or de-certified and not subject to those rules. In some jurisdictions, specific RSIs may also offer discounts or incentives to some customers resulting in rents and fees that are significantly different from the standard price. Such arrangements are not usually made public, and may not be known by the trading venue whose market participants use the RSI for storage and delivery of commodities.

The Storage Report identified the practice where RSI owners discount storage fees (or “rent” as it is referred to in some markets) in an effort to incentivise customers to continue to store the underlying commodity in their RSI, which may earn additional rental. Additionally, some RSIs may use incentives to create congestion or queueing that result in delivery delays. This may have two negative effects:

- When the commodity backed by the derivatives contract is not readily accessible, but the commodity in the cash market is readily accessible, it may cause a disconnect between the physical spot price for a commodity and the traded price of the associated derivative contract either because commercial users may be prepared to pay a higher price (“premium”) to receive physical delivery of the commodity in the spot market or because the futures price is devalued to reflect the delivery delay of the commodity against the expiry of a derivative contract, or both. This counteracts one of the primary objectives of orderly derivatives markets in acting against the convergence of prices between the spot physical market and the financial derivatives market.
- The creation of queues to remove the commodity from storage may disincentivise commercial market participants from entering into centralised derivative markets in the first place, losing the benefits, inter alia, of transparency, conduct rules governing activity on an organised venue, and the prudential benefits of centralised clearing.

In order to avoid the creation of queues and consequential charging of excess storage fees by RSI owners, a number of measures are possible. However, it is important to understand the nature of commercial arrangements between RSI owners and RSI users in each jurisdiction. To the extent that those arrangements are well-established and bilateral, IOSCO notes that as regulators there is no desire to interfere in those arrangements. Within the boundaries of any fee-charging rules or guidelines set by trading venues, participants in the market should be free to enter into commercial negotiations to set an appropriate storage rental rate based upon market conditions of supply and demand. That said, to the extent that those arrangements are not yet established, or where there are issues with fees that are imposing impediments to delivery that are threatening market integrity, ROBs should consider instituting a framework that relies on the principles of transparency and non-discrimination and which incentivises on-time delivery.

To that end, there are a number of possible measures which could be taken, which would be acceptable within the normal course of commercial business.

ROBs could require that RSIs establish a fee structures that incentivises on-time delivery by making some portion of the fees payable upon prompt and reasonable delivery of the commodity from the warehouse. For example, the total fee levied may be composed in part of a daily fee based on the period for which the commodity is stored, and part a lump sum (load-out fee) which is only due and payable after load-out.

ROBs could institute a penalty structure on RSIs for failure to deliver or delay of delivery. The nature of the penalty structure would necessarily be dictated by commercial practices that are commodity appropriate, but could include a flat, pro rata or escalating scale.

As an alternative to a penalty structure, ROBs could establish arrangements to eliminate any potential gains to the warehouse from storage queues. This could take the form of rent-capping which would limit the fees which could be earned beyond a certain period of time that a commodity has remained undelivered or by a certain volume of commodity which is in a queue.

ROBs, trading venues or CCPs may also make clear that delivery delays are an infraction of the trading venue's rules and are subject to disciplinary action. Accordingly, trading venues should establish disciplinary procedures whereby trading or participation in the delivery mechanism can be revoked or rescinded for a particular period of time and fines levied for repeated infractions. ROBs can also pursue legal action for regulatory infractions.

ROBs may also consider setting up a framework whereby the trading venue or clearing firm is responsible for the collection and distribution of the storage fees in order to make the process more transparent and provide equal, anonymised, opportunity for the use of storage facilities to the commodity owner.

Financial regulators may also encourage trading venues and CCPs to establish governance procedures for reviewing and/or approving storage fees for reasonability and in relation to the "market rate" for storage.

With respect to convergence, financial regulators, trading venues and CCPs should be cognisant of the supply and demand for storage of a given commodity and the consistency

of any trading venue-established storage fee with the commercial value of storage. In instances where the trading venue-established fee is not reflective of the true value of storage, the difference in value may be reflected in lower cash prices for the commodity and poor convergence with the futures price. Since markets are constantly evolving, trading venues should be in regular consultation with commercial market participants and have procedures in place to avoid and/or address a persistent lack of convergence.

Chapter 7 – Conflicts of interest

The Storage Report identified concerns from market participants and users of RSIs over the possibility of a conflict of interest existing if RSI operators and market participants are the same legal entity or are members of the same legal group of companies, or shared common beneficial owners.

In particular there were concerns in two areas. Firstly, there was a concern that preference was given to the operational needs of related companies, such that RSIs may prioritise their requirements to receive or deliver commodities over those of unrelated market participants.

Secondly, there was a concern that information about RSIs and the on-exchange and off-exchange stocks of commodities held within them, over and above that which is publicly disclosed to market participants in the normal course of business could be shared, and that this would give the related parties a commercial advantage in their market activities.

Conflicts of interest may be addressed through requirements for the RSI to have mechanisms to detect and mitigate all conflicts of interest, including disclosure of the conflicts and the established policies in place to address conflicts of interest.

IOSCO notes that there already exists a broad body of rules and legislation against various forms of market abuse, including trading on the basis of inside information. Nevertheless, the concern was expressed that the exercise of preferential treatment, such as the manipulation of places in the queues for delivery of commodities, may disadvantage market participants whilst not forming a type of market abuse which could be pursued under existing measures.

In recognising that regulators of financial markets generally have limited jurisdiction over physical market activities such as those of RSIs, a number of structural measures could be used to meet concerns over conflicts of interest by the exercise of authority over the activity of trading venues. This may be done through setting requirements that the rules of the trading venue which cover RSI arrangements address conflicts of interest in ways which are either structural and/or are by means of disclosure. The following ways are approaches to reducing the instance and the effects of conflicts of interest:

Trading venues or CCPs may have clearly established rules about the order of load-outs, and that preferential treatment in the receipt or delivery of commodities is prohibited.

Trading venues or CCPs should have clear processes to identify and monitor for conflicts of interests arising in RSIs and to take appropriate actions if the trading venues believes that the risks to orderly trading or settlement are sufficiently large.

Trading venues and CCPs should only permit the use of RSIs that have taken sufficient steps to identify and address conflict of interest with active market participants. For example, a RSI may be required to :

- a. disclose its conflicts of interest policy;

- b. to publish details of any identified conflicts; or
- c. to undertake external audits of its governance structures, protections of confidential information and disclosure arrangements.

Confidential information may include, but not be limited to, the identity of those holding the commodity in store, information related to proposed or actual shipments of the commodity, information related to the issuance, holding or cancellation of the delivery instrument.

Trading venues or CCPs may require that RSIs disclose to them any legal or beneficial relationships with market participants that are associated entities. Trading venues may use that information to monitor the behaviour of the parties. Alternatively, the trading venue or CCP may publicly disclose details of RSIs and their associated market participants so that other market participants are informed.

Chapter 8 – Operations

The Storage Report noted that dysfunction or disruption in the storage or delivery processes of the underlying commodity may have a material impact on price convergence and may cause market premiums for the cash commodity. Operations performed by RSIs have a direct impact on risk management and price formation and thereby play a key role in achieving convergence between derivatives and physical market prices, which affects market integrity and efficiency.

Financial regulators may require – and ROBs should generally ensure – that there is an appropriate management and record-keeping system in place for RSIs to properly record, audit and reconcile, on a periodic basis, the throughput of commodities or amount of commodities in store, as well as information, such as a legal or corporate identification number, about the depositor of the commodities in the RSI, the beneficiary and/or the legal owner. An additional measure may be the use of an electronic system with an arrangement for the flow of real time information from the RSI location to a central hub and onwards to trading venues or CCPs.

Furthermore, where the trading venue or any other entity uses an electronic recordkeeping system to track, record or register ownership or other information related to stored or transferred commodities, measures should be in place to ensure avoidance of any fraud. For instance, a central recording system should avoid that any one warrant – or any other type of title document – can be issued more than once for the same amount of the underlying commodity.

Trading venues regulate critical aspects of physical delivery, such as the location of RSIs, quality control, and load-in and load-out rates, through detailed terms in the derivatives contract specifications or in the terms of the contract between the trading venue and the RSI. In some cases trading venues use both mechanisms.

Ensuring an adequate deliverable supply and delineating terms relating to storage and physical delivery as part of the contract specifications may provide market participants with greater certainty compared to situations where delivery schedules are controlled exclusively via RSI contracts. Additionally, ROBs have greater authority over contract specifications than they do over contracts between trading venues and RSIs.

Financial regulators or ROBs could require trading venues and/or RSIs to establish an appropriate procedure for receiving complaints, handling complaints in an independent manner and providing a grievance redress mechanism where appropriate. This may include alternate delivery procedures and/or dispute resolution for delivery issues.

The Storage Report noted that there was variation in the manner in which the storage and delivery requirements are specified and publicised by trading venues. Whilst professional market participants may be expected to be familiar with the comprehensive delivery specifications and practices of commodity derivatives, occasional users of commodity derivative markets, or third parties may be less familiar.

In order to ensure that market participants have adequate information about delivery procedures for commodity derivatives, trading venues may:

- a. Ensure that the contract specifications for commodity derivatives listed on trading venues include sufficient details on delivery requirements and procedures for market participants; and
- b. Highlight where there are significant differences in delivery procedures, and explain the consequences of these differences.

Appendix 1 – List of Good or Sound Practices

This Appendix lists in a single place and in summary form the various Good or Sound Practices which are to be found in this document. The Practices listed below must be read in the context of the full document, and particularly with due regard to any legislative requirements or constraints that may affect their application.

Oversight

- RSI's linked to Trading venues or CCPs their products or contracts should adhere to the Good or Sound Practices.
- Trading venues or CCPs could depend on users of the "on-exchange" commodity derivatives to report complaints or concerns about an RSI's adherence to good or sound practices.
- The trading venue, CCP or other ROB should establish clear jurisdiction over RSIs, including minimum standards for participation and approval in their rules.
- The ROB should clearly identify a process for dispute resolution between and among market participants and the RSI, including restitution.
- The financial regulator may be able to engage with the trading venue or CCP on its compliance with, and enforcement of, derivative contract terms and conditions, relevant trading, clearing or settlement rules which may be subject to review or approval by the financial regulator.
- ROBs may require certain rules to prevent behaviours by RSI operators that could negatively impact the price discovery process.
- Financial regulators may also require that trading venues hold certain powers to resolve any negative behaviour in a timely fashion.
- Financial regulators may require that trading venues or CCPs have the ability to sanction RSIs for actions that compromise market integrity.
- Requirements should be formalised in the rules of the trading venue or CCP, in the delivery process or included with the contract or any other agreement that the RSI enters into.
- ROBs may also require trading venues or CCPs to have established governance procedures that ensure interactions with RSIs are conducted impartially.
- ROBs may also have the capability to enforce suitable standards of behaviour on trading venues.
- Trading venues may be required to provide direct or indirect access or to make information available upon demand to financial regulators.
- ROBs may require that RSIs appoint and clearly mandate a suitable person at an appropriate level within the entity or group with responsibility for adherence to the applicable rules established by ROBs or other relevant third parties.
- RSIs could adopt the broad principle of "Know Your Customer" for those entities who are the depositors of commodities.
- Legislative bodies could consider granting express direct oversight of RSIs to financial regulators.

- Where financial regulators have indirect oversight of RSI, they may also make clear in their supervision of trading venues or CCPs, that in their roles as ROBs, that the financial regulators have an interest in the activity of all RSIs which provide services that are linked to derivative contracts listed in their jurisdiction.
- ROBs may require RSIs to consent to the jurisdiction of the same financial regulator to which the trading venue on which the contract is traded is subject or to compliance with the appropriate laws or regulations of that jurisdiction.
- ROBs may also consider having appropriate information sharing arrangements in place with overseas ROBs in jurisdictions in which trading venues' or CCP's RSIs are located.
- In assessing the information sharing arrangements, ROBs should consider the extent to which the overseas ROB has appropriate powers of oversight which relate to RSIs under its jurisdiction.

Transparency

- Trading venues could make public reports which may disclose, on an equal basis to all market participants, relevant data to the type of commodity, and to the storage and delivery process of the particular trading venue.
- Data may be made publicly available by trade associations, or other third parties.
- Trading venues and CCPs could be expected to have a periodic audit procedure for RSIs to ensure compliance with the requirements of the rules applying to RSIs.
- Trading venues should have policies and procedures in place to address any RSI audit deficiencies.
- The audit procedure for RSIs could be published by the trading venue.
- Trading venues or CCPs may obtain, and to monitor, information relevant to storage and delivery of commodities within RSIs.
- ROBs should require RSIs to use best efforts to report both planned and unplanned maintenance to market participants.
- Trading venues could create or enhance the publication of information on the operational capabilities of their RSIs. This should be appropriate to the type of commodity and the nature of the warehousing requirements.
- RSIs should notify trading venues of any changes which may affect the capability of an individual RSI to facilitate properly its role in the settlement and delivery of commodity derivatives.
- ROBs should require RSIs to make timely disclosure to market participants of any changes in terms of service.
- Trading venues should keep the ROB abreast of issues related to delivery and warehousing.
- Trading venues may set a requirement in their rules that RSIs must seek approval or review of RSI fees or that fees are set in a manner with is “fair, transparent and non-discriminatory” for all market participants.

- Trading venues could consider publishing a list of available fees and discounts which are charged by and available from RSIs.

Fees and Incentives

- ROBs could require that RSIs establish a fee structures that incentivises on-time delivery.
- ROBs could institute a penalty structure on RSIs for failure to deliver or delay of delivery.
- ROBs could establish arrangements to eliminate any potential gains to the warehouse from storage queues.
- ROBs, trading venues or CCPs may make clear that delivery delays are an infraction of the trading venue's rules and are subject to disciplinary action.
- ROBs may consider setting up a framework whereby the trading venue or clearing firm is responsible for the collection and distribution of the storage fees.
- Financial regulators may also encourage trading venues and CCPs to establish governance procedures for reviewing and/or approving storage fees for reasonability and in relation to the "market rate" for storage.
- Financial regulators, trading venues and CCPs should be cognisant of the supply and demand for storage of a given commodity and the consistency of any trading venue-established storage fee with the commercial value of storage.

Conflicts of Interest

- Conflicts of interest may be addressed through requirements for the RSI to have mechanisms to detect and mitigate all conflicts of interest, including disclosure of the conflicts and the established policies in place to address conflicts of interest.
- Financial regulators may set requirements that the rules of the trading venue which cover RSI arrangements address conflicts of interest in ways which are either structural and/or are by means of disclosure.
- Trading venues or CCPs may have clearly established rules about the order of load-outs, and that preferential treatment in the receipt or delivery of commodities is prohibited.
- Trading venues or CCPs should have clear processes to identify and monitor for conflicts of interests arising in RSIs and to take appropriate actions if the risks to orderly trading or settlement are sufficiently large.
- Trading venues and CCPs should only permit the use of RSIs that have taken sufficient steps to identify and address conflict of interest with active market participants.
- Trading venues or CCPs may require that RSIs disclose to them any legal or beneficial relationships with market participants that are associated entities.

Operations

- Financial regulators may require that there is an appropriate management and record-keeping system in place for RSIs to properly record, audit and reconcile, on a periodic basis, the throughput of commodities or amount of commodities in store, as well as information about the depositor, beneficiary and/or the legal owner.

- Where the trading venue or any other entity uses an electronic recordkeeping system to track, record or register ownership, measures should be in place to ensure avoidance of any fraud.
- Financial regulators or ROBs could require trading venues and/or RSIs to establish an appropriate procedure for receiving complaints, handling complaints in an independent manner and providing a grievance redress mechanism.
- Trading venues may ensure that the contract specifications for commodity derivatives listed on trading venues include sufficient details on delivery requirements and procedures for market participants; and highlight where there are significant differences in delivery procedures, and explain the consequences of these differences.