

MARKET REGULATION

1) OVER-THE-COUNTER DERIVATIVES

The over-the-counter derivatives markets are the largest markets in the world: with little transparency and little regulation, they form a pool of huge risks. The Pittsburgh G20 hence decided on the extensive regulation of these markets by requiring that all transactions should be declared to central databases (supervision), imposing that standardized products should be cleared through central counterparties (CCPs) and subject to financial guarantees to limit the leverage effect and risks of contagion among financial counterparties (security), and making it compulsory to trade on organized markets (transparency). These reforms are to be implemented in all G20 jurisdictions by 2012. The United States and the European Union have come a long way with the implementation of the necessary legislation: all the G20 countries should now join them (hence a “red light” on the Financial Stability Board’s review table).

- **In Cannes, the G20 solemnly committed to complete this major reform of the financial sector and to align national arrangements to prevent risks of regulatory arbitrage.**

- **The G20 also decided to launch new focuses to bring national arrangements into line concerning 1) rules on financial guarantee requirements applicable to non-centrally cleared derivatives and 2) harmonization of central databases and procedures for regulator data access.**

2) MARKET INTEGRITY AND EFFICIENCY

The financial markets, and especially equity markets, have seen considerable changes in recent years. These changes are associated with: (i) the development of new technologies such as algorithmic trading and high frequency trading (HFT), which now account for 70% of trading volumes on equity markets in the United States and 40% in Europe; (ii) greater market fragmentation due to the increase in the number of dark pools. These recent developments could reduce the efficiency of the price formation mechanisms and represent new risks to the financial system, which could destabilize the economy. The flash crash in the United States on 6 May 2010 was indicative of the risks associated with these new technologies.

On France’s initiative, the Seoul G20 tasked the International Organization of Securities Commissions (IOSCO) with making recommendations to enhance market integrity and efficiency.

In Cannes, the G20 endorsed the IOSCO recommendations, which include enhanced transparency and oversight obligations for these new market technologies: stricter information obligations at all transaction stages, circuit breaker procedures and improved market abuse detection tools. This work will continue in 2012 as new market technologies constantly give regulators new challenges.

■ **The G20 also decided to take further action with:**

- **The launch of a new focus on the credit default swap (CDS) markets.** A CDS is a kind of insurance contract that counterparties can take out to protect themselves against a default (for example, a sovereign CDS protects against a default by a State). Credit default swaps are financial instruments that are often not very liquid on a market with little transparency. It is vital to gain a better understanding of their effect on the formation of prices for the assets they are supposed to protect and to take the necessary regulatory measures;
- The introduction of a **global financial counterparties identification system** (LEI for Legal Entity Identifier), with the Financial Stability Board in charge of steering the development of proposals for the next G20 Summit to be able to define suitable global governance for this powerful financial system oversight mechanism.

3) COMMODITY DERIVATIVES

The commodity markets are increasingly financialized. For example, the volumes traded on the financial oil markets are now 35 times higher than those traded on the physical markets. Commodity derivatives have evolved from their original function as simple risk coverage instruments into what are increasingly seen by many financial investors as a new asset class (hedge funds). Moreover, most of the commodity markets, such as oil and wheat, are global. At France's initiative, the Seoul G20 tasked IOSCO with proposing regulation and closer supervision of commodity derivatives.

- **In Cannes, the G20 endorsed a common regulatory and supervisory framework for commodity derivatives markets** based on IOSCO's work. This framework includes measures to enhance the transparency of these markets, tighter oversight (stricter reporting obligations) and greater powers for the market authorities. It advocates, in particular, the setting of ex-ante position limits to limit the hold an investor can have over a market in order to more efficiently combat market manipulation. The G20 has asked IOSCO to see to it that these measures are implemented by the end of 2012.