

# Regulation and the price-reporters

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The history of the relationship between regulators and commodities markets has been characterized by three questionable assumptions: that a problem exists *at all* with the measurement of value in energy and commodities; that automated measurement systems are less vulnerable to manipulation than people; and that a static measurement system can guard against potential future manipulation.

Traumatized by the example of LIBOR and some forex markets, regulators began four years with the additional ‘Medieval Witchcraft Trial’ assumption that all benchmarks are alike. To quote from the EU Parliament’s draft text from earlier in 2015 for regulating markets:

‘Serious cases of manipulation of interest rate benchmarks such as LIBOR, EURIBOR, as well as foreign exchange benchmarks, causing considerable losses to consumers and investors and further shattering the confidence of citizens in the financial sector, **as well as allegations that energy, oil and foreign exchange benchmarks have been manipulated, demonstrate** that benchmarks can be subject to conflicts of interest and have discretionary and weak governance regimes that are vulnerable to manipulation.’ (bolding added)

It takes only a moment’s thought to appreciate that an allegation cannot demonstrate anything, unless it is proven. And to say that a benchmark

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‘*can* be subject to conflicts of interest’ does not make it so in all cases.

Nevertheless, governments and the general media, in particular in Europe, have spent the past several years whipping themselves into a froth of suspicion over the state of price-reporting in commodities markets. Governments have also spent a fair bit of money, rightly so, trying to get to the bottom of their suspicions.

## IOSCO Principles

Beginning in 2011, the International Organization of Securities Commissions (IOSCO), as the body representing the majority of international financial regulatory authorities, conducted an in-depth review of price-reporting in the crude oil market, in collaboration with the IEA and IEF, and made recommendations designed to help prevent manipulation of oil price indices. Known as the ‘IOSCO Principles’, the recommendations largely codified pre-existing methodology and transparency practices, but added a layer of transparency through the recommendation that price-reporting agencies (PRAs) submit to external auditing of their price-reporting methodologies and standards.

The Principles have been embraced and implemented by all large-scale price-reporting agencies, including Platts, Argus, ICIS, OPIS, and RIM. All have applied the principles to *all* the commodities markets they cover, including those for natural gas, metals, petrochemicals, and fertilizers.

## Investigations of oil market behaviour

Not to be outdone by IOSCO, however, the EU’s competition authorities in

2013 launched a much-publicized probe into oil pricing, with raids on the offices of Shell, BP, Statoil, and Platts.

In 2012–13 Ofgem and the UK Financial Conduct Authority (FCA) meanwhile conducted an investigation into alleged manipulation of natural gas prices after ICIS reported apparently anomalous trades to them.

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**‘ENERGY TRADERS FOR THEIR PART ARE FOND OF BLAMING MARKET MANIPULATION FOR THEIR OWN MISTAKES.’**  
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Politicians are fond of saying there is no smoke without a fire. Energy traders for their part are fond of blaming market manipulation for their own mistakes.

The world has rather short memories, however. Who remembers, for example, the EEC’s 1980s investigation of alleged price-fixing in European oil markets? Or the 1936–7 US anti-trust lawsuit against Platts and 23 US oil companies, still the largest criminal prosecution ever brought in the USA. These pieces of history seem nowhere to be found in regulatory memory. Indeed, they are nowhere to be found on the Internet, either. Platts’ PR department appears to have expunged the 1930s investigation from the company’s official history, despite the fact that it exonerated the company fully; and the EU appears to have lost all records of its 1980s probe into suspected oil market malpractice.

For the record, however, let’s just repeat that neither of these historical investigations found any evidence of wrong-doing. Likewise, Ofgem’s recent gas market investigation, which focused on a particular pattern of



trading in 2012, concluded that no price manipulation had taken place. Markets await the outcome of the EU's Shell-BP-Statoil-Platts probe with interest. To date, nothing has emerged, aside from UK government criticisms of the probe as 'political posturing.'

Part of the reality is that governments, which are after all elected by energy consumers, tend to launch investigations into market manipulation when prices go up. There is no traceable history of similar investigations into *falling* prices, despite the fact that most oil market participants in the so-called developed world ought primarily to be motivated to push oil prices down rather than up, since on balance they are buyers rather than sellers.

In recent years, however, as the EU text above shows, the simple existence of investigations into possible market manipulation has increasingly been cited in media reports, opinion pieces by self-styled 'market experts', and even regulatory documents, as *evidence that the manipulation exists*.

It's interesting to note that in two years of research into crude oil markets, IOSCO's work in drafting its 'Principles for Oil Price Reporting Agencies' (produced in October 2012), cites only three examples of attempted manipulation of price-reporting agencies over the course of the previous 20 years. Of these examples, two relate not to oil price-reporting but to natural gas markets in the USA.

The remaining case, which is an oil market case and relates to an incident in 2003, is an account of an alleged attempt by Marathon Petroleum to influence Platts crude oil prices. Note the word 'attempt'. To quote IOSCO directly, itself quoting a CFTC (Commodity Futures Trading Commission) order:

'Marathon Petroleum Company LLC (MPC) settled charges for *attempting to manipulate* a price of spot cash West Texas Intermediate (WTI) crude oil delivered at Cushing, Oklahoma on November 26, 2003, by *attempting to influence* downward the Platts market assessment for spot cash WTI for that day. As a net purchaser of foreign crude oil priced off of the Platts spot cash WTI assessment *if its conduct was (sic) successful*, MPC would have benefited from lower Platts spot cash WTI assessment. The order finds that, on November 26, 2003, MPC purchased NYMEX WTI contracts with the intention of selling physical WTI during the Platts window at prices intended to influence the Platts WTI spot cash assessment downward. Further, during the Platts window, MPC knowingly offered WTI through the prevailing bid at a price level calculated to influence downward the Platts WTI assessment.'

There are three things to say about this.

- First, the final assertion, namely that Marathon 'knowingly offered WTI through the prevailing bid' appears to be incorrect. Platts insiders indicate that, at the time IOSCO's report first appeared, they checked their records and found that Marathon had not in fact 'offered through the bid' at any point. Indeed, Platts price-reporting methodologies – and those of its competitors – make it impossible for nonsense offers of this kind to be taken into account by price reporters. The methodologies prescribe that anomalous offers (or bids) are automatically ignored on the basis of the simple and logical premise that no one in their right mind would offer below an existing bid if they were

seriously attempting to sell a cargo of oil at the highest available market price.

- The second thing to note about the cited example is that it is written entirely conditionally:

'If its conduct was successful, MPC would have benefited from lower Platts spot cash WTI assessment.'

The reality is that the oil company did not benefit from lower prices, because the price-reporting agency's methodology ensured that no misconduct of the kind cited was possible.

- Thirdly, activity of this kind is already proscribed under existing law and market abuse regulation in both the USA and Europe.

The question is therefore: why is this case being cited as evidence of the need for additional regulation? The Marathon case, which is now 12 years old, appears to be the *only oil* market case IOSCO was able to cite. And it is arguably evidence not of the need for regulation, but of the success of PRA methodologies in deterring attempted manipulation.

#### **Investigation of natural gas market behaviour**

This leaves IOSCO's two cases from the US natural gas market. One relates to trading behaviour. That is, in 2008, the CFTC fined Energy Transfer Partners of Dallas Texas USD 10 million for selling 'massive quantities' of natural gas on the Intercontinental Exchange – a futures exchange – in order to drive prices down and benefit the company's swaps position.

There is no suggestion that the sale of the massive quantities did not take place. But since it is incumbent on price-reporting agencies to base the prices they report on real transactions,

it is hard to see how such behaviour could be represented as manipulation of price-reporting agencies.

This is a key point, and one that is often overlooked or misunderstood. There is a difference between pushing a market around, and pushing a price-reporting agency around.

'Manipulation', in other words, is a slippery word with many definitions. In the eyes of a regulator, a market is manipulated if a player or group of players causes prices to do something they would otherwise not 'normally' have done. This includes using a leveraged position to profit in one market area from activity in another. It also includes use of a privileged position to influence underlying supply (or less obviously, demand).

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In the eyes of a price-reporting agency, however, such 'manipulation' can only be reported on. The price of oil is whatever the price of oil is, provided that it results from market behaviour. That is to say, it is not, nor can it ever be, the role of a price-reporting agency to somehow *counteract* genuine market behaviour. A price-reporting agency cannot report what prices 'ought' to be, only what they can be shown to be. So IOSCO's second example appears to be irrelevant as well.

There are essentially only two types of activity against which price-reporting agencies should arm themselves.

These are:

- activities which create the appearance of market activity – wash-trading and its analogues, and
- outright fraud or lying.

This brings us to the final case cited by IOSCO, again from the natural gas

market. This is the now-infamous case of how, early in the 2000s, a number of natural gas traders in the USA supplied fabricated deals data to Platts for inclusion in its natural gas indices.

This may be the only established case in history of market participants successfully manipulating the *number published* by an energy price publication – rather than manipulating the market itself. Those gas traders who participated in this exercise did so by straightforward fraud: inventing trades that had never happened, and exploiting a submission mechanism that lacked a means to check their veracity.

There are two things to note about this case.

- First, it was the price-reporting agency itself, Platts in this case, that detected the fraud in 2003 and blew the whistle on it, without the presence of any regulatory framework.
- Second, that even though this is the only apparent case of demonstrated price manipulation in history, some regulators have gone on to suggest that *this very practice* – the submission of unchecked deals information into a mechanized process – is the best way to safeguard against future manipulation of price publications.

That makes little sense. Safeguarding markets against manipulative behaviour cannot be achieved by mechanization.

### Spoofing

Indeed, concerns voiced by regulators as recently as October 2015 about 'spoofing' in electronic trading systems for energy highlight the problem. Spoofing is the practice of posting bids or offers in a trading system with the purpose of creating the impression that

a tradable price exists at the posted level, and then rapidly withdrawing the bid or offer before a counterparty can 'hit' the price. Since the rules built into exchanges permit the withdrawal of bids and offers, this practice is 'permitted' by electronic systems, and is difficult to guard against.

By contrast, most PRAs have long since built into their methodologies a principle that spoofing a bid or offer by reporting it to the PRA and then 'flaking' on the price level indicated in effect constitutes a lie. To be fair to the regulators, over time first IOSCO, and latterly perhaps the EU's legislators too, have come to appreciate that such methodological safeguards are not accidental; and that the initial assumption that *all* benchmarks were somehow as compromised as LIBOR was not, in fact, correct.

Indeed it seems likely that the EU's final regulatory text will back away from lumping PRA methodologies into the same basket as those that were shown to be founded in fundamental conflict of interest. The proposed 'compromise text' of the EU's regulatory draft for financial benchmarks states, quite mildly, only that:

'All benchmark administrators are potentially subject to conflicts of interest, exercise discretion and may have inadequate governance and control systems in place.'

And the latest draft of the EU Parliament's text notes that:

'Accordingly, certain provisions of this Regulation are not appropriate to apply to commodity benchmarks. Principles developed for commodity benchmarks by IOSCO in collaboration with the International Energy Agency and the International Energy Forum, among others, are specifically designed to apply to all commodity



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benchmarks and therefore this Regulation provides that certain requirements will not apply to commodity benchmarks.'

Nevertheless, the conviction remains among many regulators that a single approach 'ought to' work for all markets.

**Automation and averaging**

This brings us to the second issue that has dogged the relationship between regulators and commodities markets: automation. And with automation: averaging.

An average is a very interesting thing, from an abstract point of view. As a statistical tool, averaging can be invaluable in providing information about everything from the behaviour of subatomic particles to the behaviour of teenagers. Averages are the cornerstone of the insurance industry. However, as any insurance broker will ruefully concede, averages are not much use when it comes to predicting floods, let alone dealing with them. The *average* height of the tide in the coastal Netherlands tells us nothing about whether or not a *specific* high tide will flood half the country.

Averages have some obvious characteristics. They are most useful – they provide most information – when they involve a very large sample, or a sample over a long period of time. They are least useful – that is to say, least likely to deliver meaningful information – when they involve a small sample or a short period of time. And, obviously, they wink out of existence altogether when the sample size hits one, or worse, zero.

This makes an average a plausible mechanism for agreeing on a typical value in a market with very high liquidity. And indeed price-reporting agencies make extensive use of averaging, under appropriate circumstances – for example in natural gas markets, where there are large numbers of deals.

Clearly, if we average foreign exchange transactions over the course of a day, we will get a number that is broadly representative of that day's activity.

Ironically, however, no one cares what the broadly representative number is. You cannot trade foreign exchange at a broadly representative number: only at the *latest* number. Similarly for stock exchanges and other very high liquidity markets. The average for the day is a statistical accident, based on the distribution of trading volume, which is a random event. *When* people choose to trade will have an impact on the resulting average. In terms of the value represented, the average therefore equates to the price at a random time somewhere between the open and the close.

If we look closer, we discover that it should also be the case that the random time represented is, to some extent, determined by volatility. The more volatile the period of the day, the higher the traded volume is likely to be, as buyers and sellers slug it out over market direction. That means in turn that a weighted average for the day will probably *over-represent* the most volatile period of trading for the day. In the worst case interpretation, the average is determined, or at least unduly influenced, by periods of atypical market activity.

The conundrum of averages gets more complicated when we start to examine the impact of averaging on markets such as those for oil, where the market's economics depend primarily not on the outright price of oil, but on the spreads between different pieces

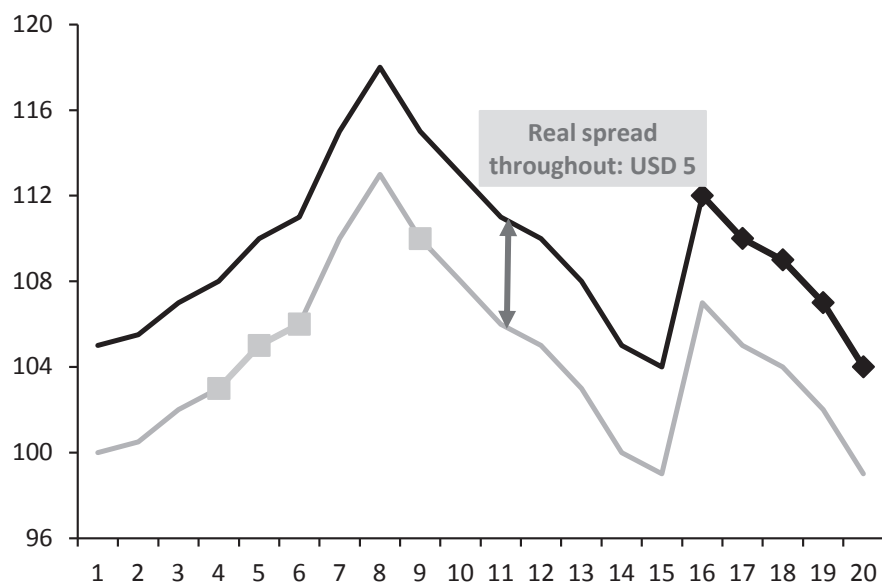
of the market complex. Those spreads can be qualitative: the difference in value between Brent crude oil and Oman/Dubai, for instance. They can be differentials in forward time: July BFOE (Brent, Forties, Oseberg, Ekofisk) versus August BFOE. Or they can be differentials in the processing chain: the spread between the price of crude oil and the price of gasoline.

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Typically these relationships are far less volatile than the outright price itself. Trading efficiency ensures it is rarely possible for a significant gap to open or close in a spread market. If crude oil tracks higher, so does gasoline.

So far so good. However, in the real world, the traded volume of physical oil is actually very low. There are not thousands of trades per day, as there are in futures markets, but literally only a handful, at best. This means that as the market complex moves higher or lower, the time at which a trade takes place has a disproportionate influence on the resulting average price.

Consider the example in the chart 'Averaging in thin markets', shown on the next page. The two markets (indicated by the two lines) have an intimately linked spread relationship: as one moves higher, so does the other. And vice versa. However, the markets in question are in the habit of trading actively at different times of the day. The market represented by the lower line trades mostly in the morning (the square points on the line), while activity in the market represented by the upper line is concentrated in the afternoon (the diamonds on the line). This is not hypothetical. There are real markets which exhibit this behaviour: for example where the market represented



Upper line trades average USD 108.4

Lower line trades average USD 106

Apparent spread: USD 2.40

**Averaging in thin markets**

by the upper line has a close relationship with another geographical market that is not open at a time when it is morning for the market represented by the upper line – as happens with European and US markets, obviously.

In the example, a succession of lower line trades occurs during the rising market of the morning. The afternoon sees markets fall somewhat and five upper line trades yield an average of USD 108.40. This compares with the lower line trades averaging USD 106. There is an apparent spread between lower and upper of USD 2.40. But this spread is entirely inaccurate. The real gap between the lower and upper markets is more than twice the spread indicated by the average: it is USD 5/barrel.

Clearly, under these circumstances, any price determination system that produces such an anomalous outcome is not to be trusted. Yet indexation based on weighted averaging is the recommendation for all price determination methodology that we see coming from many regulators the world over. This is not to say that weighted averaging does not have a place. As noted it works well in some markets

and is used by PRAs where appropriate. But it is clearly inappropriate in thinner markets, and positively misleading in markets where inter-product spread relationships are important.

There is also a school of thought which says that more reliable benchmarking may be obtained by averaging *not just* the transactions for the day, but also the prices published by a range of price-reporting agencies.

However, if agencies B and C have better methodologies than agency A, then surely including agency A's number in the mix simply dilutes the quality of the supposed benchmark? You don't get better wine by mixing the output of the top Bordeaux vineyards with the output of wineries in Scotland. In fact, averaging the prices published by multiple pricing agencies is almost guaranteed to result in a 'muddy' number – representative of neither one methodology nor another.

**Static model vs evolutionary and use of 'judgement'**

This brings us to the third major theme: the difference between a static model, and an evolutionary one.

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 '... THE TERM "JUDGEMENT" HAS BECOME PEJORATIVE IN SOME QUARTERS, IN THE CONTEXT OF DETERMINING MARKET VALUE.'  
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In the idealized world of the politician seeking to protect consumers from market manipulation, price determination should be taken out of the hands of those who might fall prey to such manipulation and be entrusted to mechanized systems, robots in effect, that do not use things like 'judgement' as tools in price determination. It's interesting that the term 'judgement' has become pejorative in some quarters, in the context of determining market value. It's as if the term implies that wide-eyed price reporters are making arbitrary decisions about what prices should be, without regard to what is actually happening in the market-place. That picture is quite false.

'Judgement' at price-reporting agencies enters the picture in two ways:

First: in *determining* what parameters should be used in the creation of a market-measurement methodology;



and when it is appropriate (with market consultation and input) to change those parameters.

Second: in the *application* of the methodology itself, judgement can be used, under exceptional circumstances (accompanied by an explanation as to why) to deviate from a strict application of the rules (which a robot would always enforce) to ensure that the *objective* of the methodology is achieved in the face of anomalous data. This can happen, for example, in relation to a transaction that *appears* to conform to the rules of the methodology, but violates its spirit.

No regulatory regime, and no methodology can ever fully deter a single rogue trader from attempting to manipulate a market. The purpose of the application of judgement in methodology design and its application is to forestall such attempts.

The objective of price-reporting agencies is in general to report prices at which transactions are typically possible. For this reason, they usually express price assessments in terms of a range – the meaning of that range is usually: ‘a typical deal is possible in this market at a number between price A and price B’. *Judgement* enters the picture because of that term ‘typical’. In theory a transaction is possible at any price. But the PRA must determine if the price is a one-off ‘unrepeatable’ fluke, an attempt at manipulation, or genuinely representative of market value. This requires investigation of the circumstances surrounding the transaction, and, especially, consideration of data that is not transactional – in particular the prevailing levels of bids and offers at the time of the transaction.

All these things inevitably involve the thing called ‘judgement’. No conceivable automated rule on earth can perform as well as human intelligence in sorting ‘representative’

from ‘borderline’. And, it must be remembered, eliminating the borderline is 95 per cent of the job of the price-reporting agency. It may be that PRAs discount large numbers of perfectly genuine trades in the process of arriving at their market prices. Indeed, this is probably one of the reasons why market participants are given to complaining about PRAs: they are inherently conservative, and will discount a transaction if there is a reasonable possibility that it is non-repeatable – the product of fluke or deliberate manipulative intent.

**Rationale for IOSCO recommendations**

Ultimately, IOSCO showed in-depth understanding of this state of affairs in producing its final recommendations for the crude oil market, in acknowledging that there are markets in which seemingly concluded transactions alone cannot determine value. IOSCO was criticized in some quarters for taking this position. But it was correct to do so.

It also showed substantial restraint in the matter of the disclosure of *process*. There is a school of thought which would demand that all methodological process be laid bare in the interests of benchmark transparency. The counter-argument, which has prevailed under IOSCO for now, is that full methodological disclosure is analogous to requiring banks to publish details of their security systems.

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**‘IT IS IMPOSSIBLE TO DESIGN A MECHANISTIC PRICE DETERMINATION SYSTEM THAT WILL NOT FAIL UNDER EXCEPTIONAL CIRCUMSTANCES ...’**  
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If we hand determination of market value to the robot, the robot will typically include flukes and anomalies in its price assessments. Worse, it may also include deals that are manipulative in intent or fall outside the bid/offer

range. It is impossible to design a mechanistic price determination system that will not fail under exceptional circumstances, and which is not susceptible to evolving market sophistication or deliberate attempts to ‘game the system’.

**Price settlement methodologies**

If we look at the methodologies for price settlement of all futures exchanges the world over, the problem becomes apparent. Typically, these methodologies will state that settlement prices will be determined by averaging the final x minutes of trading in the course of the day. The assumption is that the final x minutes will always contain enough trades to make this possible. This is fine – usually – in successful, active, liquid markets. However, for newly launched futures contracts the assumption that trading volume will be sufficient at the close for this rule to work is distinctly unproven.

Therefore the exchange includes a second provision in its rules: in the event that there are fewer than y trades in the closing period, the settlement price will be determined by taking trades over period z. Furthermore, in the event that there are *no trades in period z either*, the settlement price shall be determined by a ‘panel of experts’. Who sits on this panel is frequently a mystery.

If a price-reporting agency were to publish such a methodology it would lose all credibility in the marketplaces it serves. The fundamental problem with the rules the exchanges outline is that the *basis of measurement* is arbitrarily changed by the rule itself. ‘The price is derived from five minutes of trading, except on slow days, when it is derived from an hour’s trades.’

There are two problems here. The first is obvious. We are not comparing like with like. The second is more

insidious. It is that the *existence of the rule* provides an exploitable trading opportunity.

This has important implications for how best to manage price determination in markets where volume is not guaranteed – that is to say, physical commodities markets. The creation of rules also creates trading opportunities. This is true whether a robot is in charge or not.

If I declare that markets will be measured at 4.30 p.m. each day, traders interested in the outcome of that measurement will tend to try to execute a trade at 4.30 p.m. If I declare that markets will be measured by averaging all trades over an eight hour period, traders interested in the outcome of that measurement will try to execute as many trades as possible at a price which favours their position. There is nothing to stop a trader from buying and selling at the same price. Indeed, it's a commonplace. The fact that if I buy at USD 100 and sell at USD 100 I have created two verifiable transactions, both at USD 100, *without spending any money* at all and this does not seem to worry the fiercer advocates of averaging. In a thin market, however, we can argue that it *should*. Even, indeed, in a not-so-thin market.

One of the great disadvantages, indeed, of electronic trading is that it is typically anonymous. It is hard to determine whether 500 transactions at USD 100 are the result of 250 buyers buying from 250 sellers, or two people selling and buying from each other by pre-arrangement at an identical price. One of the great and overlooked advantages of price-reporting agencies is that they are typically aware of the identities of who sold to whom, even if they agree not to disclose this information, and repeated to-and-fro *de facto* wash trading of the kind suggested is easy to detect.

### Transparency and evolution of methodologies

The assumption on the part of politicians that exchange-based trading is somehow safer from manipulation is thus arguably one of the bigger errors in this whole debate. There is no market on earth, we might assert, that is more transparent than the North Sea physical crude oil market. Every trade is reported, by multiple PRAs, and indeed by brokers. The names of the parties to every trade are reported. The individual bids and offers leading up to their trades are also reported, and commented on. The news that drives the price is reported in real time by at least four independent global news-reporting organizations. The physical prices themselves are invariably constrained, indeed virtually dictated, by one of the most liquid futures markets on the planet. Deriving the physical price of BFOE from market activity is arguably the easiest market-reporting exercise on the planet.

Why then was this market the focus of so much scrutiny four years ago? Answer: at heart, because the price of the commodity was five times higher than it was a decade ago. Indeed, if the EU backs away from some of its more draconian ideas for regulating commodities markets today, it may well be in part because the political pressure to *act* has evaporated with the fall in energy market prices since mid-2014.

However that may be, the ability of PRAs to report this and other markets successfully is critically dependent on one thing – the freedom to evolve and adjust market reporting methodologies as markets themselves evolve. A methodology that works today may not work tomorrow.

The greatest danger inherent in the attempted regulation of commodities markets is therefore not the tendency of

regulators to prefer statistical methods over time-specific ones, or to assume exchange-trading will eliminate the potential for market manipulation. It is the tendency to believe that once a problem is solved, it is solved.

In short, the temptation to impose static rules on price-reporting organizations has more potential to damage the good functioning of energy and commodities markets than any other step.

So what does success look like?

Unless we can change human nature we need to accept that from time to time someone will attempt to break the rules and try to influence a market unfairly. The politician's dream of legislating attempted manipulation out of existence is just that: a dream. The efforts of EU regulators to impose additional governance constraints on PRAs emerges in this light as just that: a desire for control, rather than a desire to reduce manipulation, and one that could have dangerous consequences for proper market function if the control sought impedes free competition among PRAs or prevents them from doing their jobs.

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**'THE MARKET NEEDS A CERTAIN LEVEL OF TRANSPARENCY TO ENSURE ATTEMPTS TO MANIPULATE ARE EXPOSED.'**  
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The market needs a certain level of transparency to ensure attempts to manipulate are exposed. This means it needs independent parties observing markets – price-reporting agencies in other words – who are in a position to spot the behaviour, and have the freedom to evolve their methodologies as markets themselves evolve; and then we need regulators to address the behaviour.

This describes exactly the situation we see today in commodities markets. We tamper with this situation at our peril.

