

Commodity Derivatives Markets: Regulators' leap in the dark?

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Information asymmetries are pervasive in the financial services industry, but the lack of transparency in commodity derivatives markets is particularly striking. Over 85% of commodity-derivative trading worldwide takes place over-the-counter (OTC) and information regarding both the fundamentals of commodity markets and the pricing mechanisms of commodity derivatives is patchy at best. Moreover, calls for evidence regarding the role of speculators in driving up commodity prices on both sides of the Atlantic have failed to entice comprehensive and unbiased reports on commodity derivatives. Thus, in light of the entrance of institutional investors in commodity derivatives, public authorities must rely on scarce empirical evidence and consult closely with market participants to enforce and devise regulation.

Commodity derivatives are not new. Forwards on agricultural products have existed for centuries: some cite early evidence of these types of contracts in pre-Christian civilisations. *Forwards* are defined as contracts between two parties to deliver a certain product at a certain date at an agreed price. On the other hand, *futures* are standardised forwards freely exchangeable on the market: they first appeared in Chicago in the 1840s. The existence of exchanges has facilitated the matching of buyers and sellers of contracts, thereby increasing the liquidity of these markets. The historical role of forward and future contracts has been to 'hedge' against inherent risks existing in commodity markets. In effect, commodity prices have always been extremely volatile due to unpredictable trends and events such as floods, droughts, war, technological improvement, fluctuations of economic activity and disruption of distribution or production. Hence, thanks to derivative contracts, commodity producers and consumers have been able to manage the *commodity price risk*.

Today, however, the commodity derivatives market looks radically different. Since commodities are negatively correlated to bonds and stocks, a vast array of actors has entered the market through exchange-traded funds¹ seeking portfolio diversification. For instance, according to Michael Masters, assets allocated to commodity indexes have

¹ Exchange-traded funds are investment vehicles traded on stock exchanges in a similar fashion to stocks. Some of these exchange-traded funds are specialised in commodities and precious metals.

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shot up to \$260 billion in March 2008 from \$13 billion at the end of 2003.² As a consequence, commercial players who want to hedge against commodity price risk in the underlying commodities have been increasingly outnumbered by institutional investors betting on future prices. According to estimates of the Commodity Futures Trading Commission (CFTC), while overall open interest in West Texas Intermediate (WTI) derivative contracts traded on the New York Mercantile Exchange (NYMEX) has tripled since 2004, the activities of non-commercial entities have risen six-fold over the same period.

The commodity derivative industry is mostly unregulated. In the US, after the approval of the Commodity Futures Modernization Act of 2000, OTC contracts and exchange-traded contracts amongst commercial players³ based on 'exempt commodities'⁴ do not fall under the jurisdiction of the CFTC, even though anti-fraud and anti-manipulation rules still apply.⁵ This means that for the aforementioned contracts speculative limits are not in place and market transparency is limited, making it harder to prosecute anti-fraud and anti-manipulation activities than on regulated exchanges.⁶

In the EU, specialist commodity firms are exempted from the Market in Financial Instruments Directive (MiFID) requirements under Arts 2.1(i) and (k).⁷ MiFID allows member states to put in place specific authorisation regimes for commodity firms. The UK, Italy and Norway have done so, and France is implementing some measures in this direction. The Market Abuse Directive still applies to commodity derivatives contracts traded on regulated exchanges, but this regime may not directly cover OTC markets. All these exemptions stem from the consideration that commodity derivative firms do not seem to pose any systemic risk to the financial system. Moreover, the definition of insider dealing within the Market Abuse Directive does not fit neatly with the structure of commodity markets, whereby producers hold inside information thanks to the involvement in the underlying commodity. That said, no country in the EU has in place

² Testimony of Michael W. Masters, Managing Member/Portfolio Manager of Masters Capital Management, LLC before the Committee on Energy and Commerce, Subcommittee on Oversight and Investigations, United States House of Representatives, 23 June 2008.

³ In the spirit of the legislation, commercial players pursuing hedging strategies for the price risk in the underlying commodity market should be subject to a different regulatory framework than non-commercial players using derivative markets to make a profit. However, by using swap transactions, which are outside the reach of regulation, non-commercial entities can circumvent the legislation and escape public authorities' oversight.

⁴ 'Exempt commodities' are all non-financial commodities except agricultural products. Therefore, exempt commodities are mainly energy and metals. This provision is popularly referred to as the 'Enron loophole'.

⁵ The US Congress overrode the President's veto on the Food, Conservation, and Energy Act of 2008 on 18 June 2008. Some provisions attempt to close the Enron loophole by granting larger regulatory authority to the CFTC. However, the CFTC has interpreted this provision in a restrictive fashion and they intend to fully regulate only Intercontinental Exchange's Henry Hub natural gas futures contracts.

⁶ Moreover, certain exchanges are exempted from CFTC supervision under the Foreign Board of Trade exemption. If the CFTC deems that foreign regulators have put in place a regime that provides enough supervision, they can issue a 'no-action letter' granting authorisation to operate in the US market. For instance, the UK's Intercontinental Exchange operates a multilateral trading facility in Atlanta, Georgia dealing with US customers on US soil with US dollars in cash-settled futures on WTI crude oil with sole UK supervision. This is generally referred to as the 'London loophole'.

⁷ These issues are currently under review by the DG Internal Market and Services of the European Commission, which is due to submit a proposal by the end of 2008.

speculative limits on positions similar to those applicable to some derivative contracts in the US.⁸

In spite of the political pressure to act on commodity derivatives, market participants such as hedge funds, unregulated exchanges and information providers of commodity markets contend that calls for further regulation are largely misplaced. Their arguments move along five vectors. Firstly, future prices have no impact on spot prices, which are driven by underlying fundamentals in the market for the physical commodity. Secondly, because users of commodity derivatives are overwhelmingly sophisticated wholesale players with enough resources and knowledge to cope with information asymmetries, disclosure requirements are burdensome and futile. Thirdly, speculation limits, higher margin calls and the banning of institutional investors⁹ from commodity derivatives would decrease market liquidity, increase the cost of hedging for commercial entities and make markets more inefficient. Fourthly, commodity firms argue that market manipulation issues – such as “corner” and “squeeze” techniques¹⁰ – are properly addressed by the Commodity Exchange Act of 1936 in the US and the Market Abuse Directive in the EU. Finally, citing the instances of Amaranth Advisors LLC, Metallgesellschaft AG, Enron and Sumimoto as defaults on commodity derivative positions, commodity firms argue that they do not pose any systemic risk to the larger financial system and no capital requirement should be set.¹¹

These rather dismissive answers have failed to convince politicians – under pressure amidst rising inflation and deteriorating economic conditions – that speculators are not responsible for the surge in commodity prices. Furthermore, in the wake of the subprime lending debacle, the financial industry’s record looks quite abysmal: the

⁸ In the US, speculative limits are in place to prevent non-commercial entities from manipulating commodity markets. In these markets, finite supply constrains production, and positions in the secondary market can squeeze the physical market. In the words of an authoritative report: “Due to the characteristics of markets for non-financial commodities with finite supplies, however, the Working Group is unanimously recommending that the exclusion [from CFTC supervision] not be extended to agreements involving such commodities. For example, in the case of agricultural commodities, production is seasonal and volatile, and the underlying commodity is perishable, factors that make the markets for these products susceptible to supply and pricing distortions and to manipulation. There have also been several well-known efforts to manipulate the prices of certain metals by attempting to corner the cash or futures markets. Moreover, the cash market for many non-financial commodities is dependent on the futures market for price discovery” (*Over-the-Counter Derivatives Markets and the Commodity Exchange Act*, Report of the President’s Working Group on Financial Markets, November 1999, 16, writing in italics added). In this sense, the Commodity Futures Modernization Act of 2000 violates these recommendations as energy and metals are exempted from CFTC supervision.

⁹ Several pieces of legislation were introduced in both chambers of the US Congress implementing some or all these measures. Among others, H.R. 6341 co-sponsored by Congressman Van Hollen and Congresswoman DeLauro aimed to impose speculative limits on non-commercial entities, to close the Enron loophole and to bring all energy derivative contracts onto regulated exchanges.

¹⁰ “When ‘cornering’ a market, a manipulator builds up large positions in the underlying commodities market in order to create an artificial shortage. This is usually done in conjunction with long positions in the forward/futures market. The manipulator will then demand delivery of the commodity (i.e. squeeze the market). As he simultaneously withholds his stock of supply, the sellers of the future will find it hard to acquire enough of the commodity to fulfill their contracts. The manipulator can then use his market power on the commodity market and charge high prices for his stock of the commodity.” *UK Discussion Paper on The Commission’s Review of the Financial Regulatory Framework for Commodity and Exotic Derivatives*, HM Treasury and FSA, December 2007, p. 22.

¹¹ CESR and CEBS are considering whether to allow commodity firms to opt-in in some sort of capital requirement scheme in order to obtain a passport to operate EU-wide.

defence of derivatives by the financial press and regulators has fallen short of assuaging public concerns.

In addition, as far as regulators are concerned, there is a related issue worth discussing: to what extent are public authorities willing and able to make decisions reflecting the general interest? Finance is a highly innovative sector and regulators sometimes do not fully grasp the consequence of market developments. Because of this information asymmetry, market participants may be able to mould the regulatory landscape to their advantage. This could be particularly true for commodity derivatives, whereby OTC markets are predominant,¹² specific data are missing and the understanding of markets is confined to a restricted number of players.

By withholding information on the functioning of commodity derivatives markets, financial actors risk overregulation following a political backlash. Thus it is in the interest of market participants to answer a number of questions: How are spot prices determined in commodity markets? How do derivative markets in soft, metal and energy commodities work? What is the relationship between future and spot prices in each of these commodities? What explains the overwhelming preference of market participants to utilise OTC commodity derivatives and their apparent reluctance to employ more liquid exchange-traded futures and options? In the face of booming activity, is it still true that commodity derivative markets do not pose significant systemic risk? Why do certain US speculators use swap agreements to appear as ‘hedgers’ to American regulators? Why are certain fully regulated US exchanges trying to escape supervision by registering as Foreign Boards of Trade? Is the entrance of institutional investors in commodity derivatives weakening the price discovery function of these markets?

The political outcry about commodity derivatives may be misplaced, but it is the result of a failure to communicate. The stakes are high, and more clarity and transparency on the part of market actors would go a long way towards addressing public concerns and restoring market confidence.

¹² Even though a rising number of OTC commodity contracts have been standardised – thereby migrating to multilateral trading facilities, which partially monitor transactions – the majority of these are still bilateral brokered deals.