US Commodity Trading Regulation

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Commodity Trading Regulators

- Commodity Futures Trading Commission (CFTC)
- CFTC is successor agency to GFA (1922) and CEA (1936).
- It was established in 1975
- Federal Energy Regulatory Commission
- Successor agency to NGA and FPC
- It was established in 1977
Legislative Authority

- CFTC operates pursuant to the Commodity Exchange Act, first passed in 1936, with significant amendments in 1975, 1992, and 2000
- FERC operates pursuant to the Federal Power Act and the National Gas Act, and subsequent amendments thereto
CEA effectively expanded 1922’s Grain Futures Act to cover other physical commodities.

Main legislative goal of CEA is to prevent and diminish price manipulation and “excessive speculation”.

As originally envisioned, this goal would be achieved by requiring all “contracts for future delivery” to trade on “designated boards of trade” that were charged with controlling speculation and manipulation.

Use self-regulation to achieve policy objectives.
Contract Market Designation

- Contracts for “cash” commodities exempted from the exchange trading requirement
- Originally aimed at “bucket shops,” and arguably a measure to protect exchanges from competition
- Congress believed that threat of removing contract market designation would ensure that exchanges had an incentive to crack down on manipulation and excessive speculation
- Proved to be a very blunt instrument, and amendments to CEA give CFTC more direct oversight into and authority over markets
One Size Doesn’t Fit All

- Ever since the passage of the GFA and the CEA, the exchange trading requirement has proved problematic
- What is a “future”? What is a “cash contract”?  
- Requirement constrained innovation and competition, and created legal risks (people tried to escape OTC obligations by arguing that they were illegal, off-exchange futures)
- Over the years, this problem finessed with no action letters, policy statements, court and enforcement decisions
The growth of OTC markets in the 1980s and 1990s increasingly made the CEA framework and the Rube Goldberg fixes obsolete, and legally dangerous. OTC market participants extremely concerned that exchange trading requirement posed very serious legal risks for swaps, etc. In 2000, Congress passed the CFMA in large part to create legal certainty for OTC markets. This Act often cited as a culprit in current financial crisis. Don’t believe everything you read.
CFMA Controversy

- CFMA exempted some electronic commodity markets ("designated transactions facilities") from some (not all) regulation—anti-fraud and anti-manipulation parts of CEA still apply.
- Individually negotiated swaps between professional traders exempted from exchange trading requirement.
- Essentially created a distinction between markets serving professional traders only, and those also serving public/retail traders.
Manipulation

- Preventing and diminishing price manipulation has been a goal of US commodity law since its inception in 1922
- Problem: what is manipulation?
What is Manipulation?

- “It is my experience that manipulation is any practice the person speaking at the moment.” (Texas cotton broker William Clayton, 1923).
- Senator Norris’s lament
  - “We think the test of manipulation must largely be a practical one if the purposes of the Commodity Exchange Act are to be accomplished. The methods and techniques of manipulation are limited only by the ingenuity of man.” Cargill v. Hardin (452 F.2d 1154, 8th Circuit)
Corners, Squeezes, Hugs

- Corners, squeezes & hugs—the exercise of market power—is a well recognized form
- Large long accumulates more contracts than can be satisfied by delivery at the competitive price
- Forces shorts to choose between incurring excessive cost of making delivery, or buying back contracts at an inflated cost
- EG, Ferruzzi, Solomon Bros., Sumitomo, and on and on
What a Squeeze looks Like I

Crude Oil Spread for October and November 2008 Delivery
6/22/08 – 9/22/08
Source: Bloomberg

Note: Based on daily closing prices for October and November crude oil. Calculated as October price - November price.
3:2:1 Crack Spread for October 2008 Delivery
6/22/08 – 9/22/08
Source: Bloomberg

Note: Based on daily closing prices of October crude oil, RBOB gasoline, and heating oil.
Market Power is Costly

- Exercise of market power results in distortions in prices
- “Real” distortions in commodity shipments, production, and storage
- Degradation of effectiveness of derivatives as a hedging vehicle
Ex Post Deterrence

- Manipulation is a felony (ask BP). CFTC can impose civil penalties, and is asking for criminal authority.
- Right of private action (e.g., class action lawsuit).
- These impose penalties ex post that should deter manipulation.
- Unfortunately, law in this area is a mess (that’s a technical term).
Legal Standards

- Finding of manipulation involves proving:
  - Artificial price (price not reflective of supply and demand)
  - Accused had the ability to cause an artificial price
  - Accused did cause the artificial price
  - Accused acted with specific intent
- Some reasonable decisions (Cargill v. Hardin)
- Others are riddled with fundamental logical errors (esp. in re Indiana Farm Bureau, in re Cox & Frey) (See Pirrong, 1996, 1997)
- It is possible to use rigorous economic/statistical methods to test each of these (Pirrong, 2004), but . . .
Ex Ante Prevention

- Position limits: prevent firms from accumulating positions big enough to manipulate
  - Problem: some traders have legitimate reasons to amass big positions
  - Difficult to adjust limits to reflect changing underlying fundamentals that affect contract susceptibility to manipulation

- Emergency authority: exchange can force liquidations or other measures

- Contract design

- Exchange self-regulation has proved problematic (Pirrong, 1995)
Anti-Speculation

- CEA requires exchanges to adopt measures to eliminate “excessive” speculation
- Uhmm, what’s excessive?
- Position limits impose restrictions on speculators
- Position limits are now all the rage in Congress
- These limits can interfere with the ability of the market to perform its economically vital risk shifting and price discovery functions
Back to the Future

- Financial crisis has led to numerous initiatives to impose more regulation on derivatives markets
- Some proposals would force all trading onto exchanges—just like the GFA of 1922
- This will prove no more workable today than it did then
- Intense interest in expanding scope of position limits (OTC positions, index positions)
- This is a throwback merely to 1936.
- “Insanity is doing the same thing over and over, and expecting a different result.”
- “When all you have is a hammer, everything looks like a nail.”
FERC’s regulatory authority over certain energy derivatives trades is very new, dating from 2005. FERC anti-manipulation rule is patterned on the Securities Act anti-manipulation provision.

SEC. 4A. It shall be unlawful for any entity, directly or indirectly, to use or employ, in connection with the purchase or sale of natural gas or the purchase or sale of transportation services subject to the jurisdiction of the Commission, any manipulative or deceptive device or contrivance (as those terms are used in section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78j(b))) in contravention of such rules and regulations as the Commission may prescribe as necessary in the public interest or for the protection of natural gas ratepayers. Nothing in this section shall be construed to create a private right of action.
An Evaluation of the FERC Rule

- This is, how should I say it?, ridiculous
- The most important types of commodity market manipulation are market power manipulations
- Due to information intensity of securities prices, “fraud and deception” standard makes sense in a securities context, where many manipulation strategies employ fraud (e.g., “pump and dump”)
- FERC rule (courtesy of Congress) is complete mismatch with commodity market conditions
FERC Enforcement

- FERC is anxious to use this newfound authority, especially given the current political climate, and the new FERC leadership, and because that’s what regulators do
  - Amaranth
  - ETP
- Problem: round pegs, square holes. How do you pound a market power manipulation peg into a fraud-and-deceit hole?
Carbon Trading, Manipulation, and Speculation

- Carbon derivatives trading, unless banned, is likely to develop once cap & trade takes off.
- Market power manipulation could occur in these markets. They would arguably develop similarly to government security markets, where manipulation has occurred with some frequency (a dirty little secret, but it’s true).
- Speculation, the mirror image of hedging, also likely to occur.
Carbon Trading Regulation—Up in the Air

- Exchange trading, OTC, or both?
- Ban derivatives? Is that even possible?
- Restrict speculation (position limits)?
- International scope of markets—jurisdictional issues
- Who will regulate? In the US? Internationally?
- Vanilla derivatives—futures, forwards, options, on standardized credits
- Offsets, and products created from offsets (CCO—collateralized carbon obligations)