CPM Group

Market Commentary

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Regulatory Risks to the Commodities Markets

The following text is based on presentations made at International Precious Metals Institute conferences by Jeffrey M. Christian, CPM Managing Director, in May 2011 and Rohit Savant, Senior Precious Metals Analyst, in June 2011.

The title of our presentation is "Regulatory Risks to the Commodities Markets." We would like to start by saying that there are a two misnomers imbedded in this title. It is not just regulatory risks that the commodities markets are facing. There also are legislative, enforcement, and, soon, litigation risks. It now is clear that at least some of the actions that some governments are suggesting they will undertake in commodities markets in the name of making them safer for investors or to curb speculative excesses will end up in the courts.

The second point is that these issues apply not only to commodities markets, but also to derivatives markets across all financial markets, banking regulations, and the regulation of non-bank financial institutions.

These two points are important for at least two reasons. First, it would be entirely avoidable if legislators, government administrators, and regulators did their jobs properly and knew what they were doing. Second, the process from legislation to regulation, and then to enforcement and ultimately litigation will delay any real, effective reforms of commodities markets for years, if not decades. So, the entire commodities market system and everyone in it will remain at risk of the excesses and misbehavior that has characterized markets in recent years.

Additionally, we have to focus on proposals to regulate the derivatives markets when considering the risks to the commodities markets. Commodities are a very small part of the derivatives markets, but the derivatives markets are a very large part of the commodities markets. Some of the derivatives regulations that have been discussed in Washington and Europe could destroy these markets and freeze credit markets in ways far worse than was experienced in late 2008. You must not consider only those regulatory initiatives specifically targeting commodities, because banking reforms and derivatives market reforms can have just as devastating an effect on commodities markets' ability to function.

It is not just regulatory risk but also legislative risks that the commodities markets are facing. There has an enormous amount of discussion about the Dodd-Franks legislation and its potential effects on a range of financial markets and transactions. There will continue to be an enormous amount of debate about the effects of Dodd-Franks. If we are lucky, this discussion will end with this legislation being repealed replaced with a series of realistic, reasonable, honest, and fair laws and regulations aimed at real reform of financial markets. No one should hold their breath waiting for this development.

Furthermore, there are issues related to enforcement. There have begun to be a number of enforcement actions related to activities in commodities and other financial markets. Many of the enforcement actions appear to be geared toward publicity and trying to justify the continued funding and existence of regulatory bodies that clearly were too lax in the past, allowing for a range of bad habits to affect markets. A number of the enforcement actions that have been publicized appear to be based on bad analysis of trades and insufficient information for successful prosecution. They seem more like grandstanding than real, effective enforcement.

Finally there are litigious risks. Already there is a growing chorus of market participants who have grown frustrated at the seemingly misdirected regulatory and legislative processes, and are preparing for the inevitable need to sue for injunctions against these poorly designed regulations being enforced. For example, the Commodity Futures Trading Commission (CFTC) is asking for comments on swap regulation. It was supposed to have its swaps regulations in place by 16 July, under the guidelines in Dodd-Franks. However, the CFTC has yet to define what it means by the term "swap." Swaps are defined in different ways, and the CFTC needs to decide what it means by swaps before it can regulate them. The CFTC still is struggling with how it will define swaps, but nonetheless until the middle of June was seeking comments on

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swap regulation proposals. The industry was asking for more time to structure these regulations in an informed way, asking the CFTC to please inform the market from a regulatory perspective what it thinks it means by swap before requesting public comments on its proposals to regulate the swap market. On 14 June the CFTC voted to postpone the rules regulating derivatives trading to December 31, 2011, which is not enough time for it to do its job in an intelligent, informed, and effective manner. Given that sort of behavior, it can be seen why we say all of this is definitely going to be litigious.

The Risks

There are a host of risks to markets properly functioning in the current round of regulatory reforms. First and most obviously: Poorly constructed regulations can freeze markets and lead to financial catastrophes.

Poor Regulations Can Kill Markets

In the years following the last round of financial market scandals, in 2001 – 2003, there was a round of calls on the part of politicians to regulate derivatives markets. This was after the Enron scandal and others. The legislation that was drafted and introduced into both houses of Congress would have, among other things, made it illegal to modify or close out a hedge position prior to maturity. That is what the Congress people who had introduced the legislation were proposing. That would have killed the use of any derivatives to hedge any currency, commodity, interest rate, or other risks.

Regulatory Arbitrage

Since trading will occur regardless of the existence of poorly designed regulations in individual countries, there is a real risk that bad regulations in the United States or Europe would lead to 'regulatory arbitrage,' with trading migrating from regulated markets to unregulated markets, either over the counter or overseas.

Volumes in the U.S. regulated futures and options markets are already migrating overseas. The U.S. markets could lose half of their market share within six months to a year of bad regulations being imposed. Capital controls are low and money will flow to efficient markets. London's over the counter market would love to take market share from the United States. Canada, Japan, and Europe are all positioning themselves to benefit from such a change.

Speculative Position Limits

The enabling legislation in 1974 that created the CFTC gave the CFTC the authority to put speculative position limits on commodities futures contracts. It has never imposed them because it has let the exchanges do that. In the more effective periods of the CFTC's existence, the commission would interact with the exchanges, supervising the exchanges and providing oversight of the setting and maintenance of position limits imposed by the exchanges: Why the position limits were set where they were, what they might or should be, what are the parameters used in deciding position limits? They would let the exchanges, which are by definition closer to the markets than regulators, manage those position limits. The CFTC never really engaged in setting limits on its own. Starting in 2009 the CFTC began considering changing this policy.

In trying to understand what the CFTC is doing now regarding position limits, it is important to keep in mind that the CFTC still has the right to impose position limits. That is important because it brings up the questions of why the CFTC held hearings on the subject last March and why it is going through this whole process. One might easily conclude that this is all a political show. If the CFTC wants to regulate, it should regulate. It has the authority. When you hold a hearing to see if you should create regulations that you actually have had the authority to establish for 35 years, you do not present an image that you are serious about creating those regulations. You appear to be engaging in political theatre.

On top of all of this, if you look at what the CFTC was proposing, it was proposing imposing position limits on energy commodities and metals that were far higher than the position limits that the exchanges have already imposed for years. So they are talking about imposing worthless position limits. Given these facts, you have to stop and ask what motives they had for doing this.

Commercial Position Limits

One of the other restrictions being discussed that is very worrisome is the idea of imposing position limits on commercial entities and hedgers. A couple of the CFTC commissioners seem not to understand what commercial companies, primarily banks and other financial institutions, do in commodities markets, and why they have these large positions. Regulators and their associates have said that it is all right for commercial companies to have large posi-

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tions in futures and options, but not banks. Those banks are the commercial entities that provide market making services and liquidity to the commodities markets, however, and hedging their positions in futures and options is a crucial tool they need in order to stay in business.

The reaction is that mining companies, industrial users, and refiners are legitimate commercial enterprises engaged in futures and options. Most mining companies, fabricators, and refineries do not trade directly on the futures market. They go into the OTC market, to their banks and structure a forward trade. Then the bank hedges its trade in the OTC market, often but not always in the futures or exchange traded options markets. These banks represent the bulk of the commercial trades on futures markets. The banks are providing the liquidity and price risk mitigation for industrial companies that allows the economy to function. Their presence in these markets allows producers, refiners, and consumers to produce, refine, and consume.

There are plans to impose position limits on commercial enterprises. There is internet chatter about how three banks have an enormous percentage of the long commercial position or short commercial position in silver or gold. If you look across commodities markets you see that in most commodity markets it is two, three, four, or five banks that have the majority of the positions. This is not because they squeezed out their competition. It is because being a commodities banker sucked money out of your wallet for many years, and a lot of banks got out of the business. It was not so much that a few banks stepped forward and took market share from their competitors. It was that they stuck around while everybody else left the room. By virtue of the fact that you are one of the last banks left standing in a particular commodity market you now have a very large percentage of the market. The fact of the matter is that they are making markets and providing liquidity that other people will not provide anymore.

The idea of imposing position limits on the last banks willing to be market makers in commodities is to kill this business. You simply cannot say that a bank or other commercial entity may not have more than 5,000 or 6,000 contracts because the banks may happen to have the equivalent of 12,000 or 20,000 contracts of OTC trades on their book. If they cannot hedge these positions in regulated futures markets, they are going to have to go elsewhere to hedge. They will go to London, or in the future, they will go someplace else.

A New Attack on Long-Term Investors

Bart Chilton is a CFTC commissioner who has taken a very outspoken stance on many aspects of the commodities markets. He has been making many unsupported statements related to short term speculators and banks as being bad for the market. In early 2011 he started talking about long term speculators as being bad. He started complaining about what he began calling "massive, passive speculators." Who was he talking about? He was talking about people who buy and hold gold, silver, and other commodities through exchange traded funds and other such financial instruments, including physical market transactions. He has been saying that investors and investment funds that buy and hold long-term, long positions in commodities now are culprits in the commodities markets. He has been saying these "massive, passive speculators" are evil. He has changed the definition of what a speculator is. We really are getting into scary things here. Clearly, speculators have become a target for both politicians and demagogues within the regulatory community.

Speculation

This leads to another set of topics: What is the definition of a speculator and who is qualified to say who is a speculator, and who is an investor? Who is a good market participant and who is a bad market participant?

India has a really bad rule in this regard. If you are an Indian, you can export money to invest overseas. You may not export money overseas to speculate. Let us say you are an Indian, and you think the price of silver could rise to $50 over the next two years. You may want to transfer funds to New York and buy some silver futures. The government says fine, allowing you to make the transfer. You put the money to work and a week later silver is at $50. You want to take your profits. You have now broken the law, because that is not a long term investment in the eyes of the Indian government; it is a speculative trade. You may have made your investment decision based on long term intentions, and you may be just a lucky investor, but now you are a law-breaking speculator in the eyes of the Indian government.

Indian government officials acknowledge that this is not right, and have been wrestling with how to correct this for years. Now, there are powerful voices in the U.S. government that say we need some over-lord within the U.S. government who is going to decide who is a speculator and

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who is an investor. The call has gone out to create some governmental position that would have the capacity to decide who is allowed to participate in commodities markets and who is not, having the discretion to come in to the office one day and decide that it was not short-term speculators who are enemies of the people, but rather long-term investors, now re-branded as speculators arbitrarily by someone who clearly does not know the definition of an investor or speculator, let alone how banks provide liquidity to global physical commodities markets and what a swap is. In reality, oil companies are speculating that the oil price will go up, and so they are drilling for oil in the western part of the United States. That's a speculation.

There is this entire set of questions about what is speculation and who are speculators. At CPM, we try not to use that term, "speculator." They are short term investors, or lucky investors. Who is going to sit there in Washington, in the government, and pass judgment on who may participate in the market and who may not.

A few years ago when oil and gas prices were very high, there were politicians in Congress who were making political hay by saying that prices of natural gas and oil were very high because of speculative buying, seemingly in total ignorance of the real world economy around them. They rolled out a fellow who will remain nameless, who was basically a speculator. He ran a small fund, probably mostly his own money. He basically shorted the natural gas market, and he became the celebrity of the moment at Congressional hearings saying over and over again that these bad speculators were driving the natural gas price up by going long. Well, he was a short speculator. In the minds of the politicians who held him forth as an expert, he was a good speculator, even though he was, gasp, shorting a commodity.

There are Republicans and others who want to ban all shorting in all financial markets, a really bad idea, based on the completely preposterous view that shorting markets is un-American and immoral. But here was this guy being trotted on national television as a protector of the Republic from evil speculators who was actually nothing more than a speculator caught short in a rising market. However, he served a political purpose, even if he spoke from a position of no authority.

Let us be honest. Speculation is being targeted and speculation is one of those things that the government has not even defined.

You have seen it in the White House. You have seen it in the Congress. You are seeing it in the regulatory agencies, at least the CFTC. You have seen it in the EU, and you are seeing it throughout the developing world. It is a real issue that could lead to massive destruction not only of real wealth, but of the economy's ability to function properly and generate more wealth in the future.

Speculation and Prices

Speculative involvement clearly affects prices. CPM does not deny that. We do not think anybody who has been involved in the commodity markets would deny that, but it also is clear that it does so in many different ways.

There are times in individual markets when speculative activity has pushed a price higher; times when speculative activity has kept the price of a commodity from rising further when its supply/demand fundamentals suggested that it should. Times when speculation have pushed prices down, and times when speculative activity has kept prices from falling as far as they might due to the fundamentals.

Similarly, there have been times when speculation has increased price volatility, and when speculation has decreased volatility. There is not anything unique in this. Anybody who does the statistics can learn this.

Speculation clearly affects prices, but it affects prices in all sorts of very complex ways, and you cannot say honestly with any authority that speculators increase volatility any more than you can say speculators decrease volatility.

Regulators and politicians in the United States and France have been complaining that the rise in energy, agricultural, and other commodities prices has been the result of the rise of investors in these markets. The chorus includes President Obama, members of Congress, at least one CFTC commissioner, and President Nicolas Sarkozy of France. Sarkozy has stated that it is his primary goal of his current presidency of the G20 to use this year to drive speculators from the commodities markets, which he has assured his listeners would lead to lower energy and food prices.

There is a vast body of good research that says that this is not so. Clearly, the presence of investors and speculators, as some people have taken to disparagingly calling investors, has had an effect contributing to the rise in commodities prices. But studies have shown, and qualitative, em-

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pirical evidence and simple logic dictate, that the upward shift in fundamental, 'real' demand for fabrication and consumption purposes has had a more important role in driving commodities prices higher over the past decade, coupled with the constraints limiting increases in production of many commodities and the rise of investor participation in long-only investment products. These facts are simply in the way of the rhetoric.

The Banks of Japan and Canada have recently published very good studies on the relationship between the presence of investors or speculators in commodities markets, and price increases and price volatility patterns over the past several years. Both studies have concluded that the presence of investors or speculators has not been the major cause of rising prices, nor a major contributing cause.

The EU meanwhile released a study early this year that initially contained the conclusion that it was quantitatively clear that investors or speculators were not the major cause of rising commodities prices. EU politicians begged to differ and demanded the study's conclusions be revised. The revised study concluded that while there was no clear quantitative link between the presence of speculators in commodities markets and rising prices, it was nonetheless obvious that speculators were behind the higher prices.

It is no accident that the Banks of Japan and Canada have issued their studies defending free commodities markets. They are sending a message to commodities trading companies around the world: We are open for business, and believe in free, well regulated markets. If the United States and France wish to drive commodities trading from their shores, chasing banks and dealers away, the commodities markets are welcome to reconstitute themselves in Tokyo and Toronto. Given current technologies, such a geographic shift could take a week or two to complete.

Derivatives

Turning to the broad derivatives markets, there is out right talk about banning derivatives, of constraining financial innovation. Derivatives are interesting things. Banks and brokers continually come up with permutations to market to their clients. These are their products and they are continually trying to come up with new trading strategies to give them a competitive edge. One of the proposed requirements is full disclosure of derivatives construction. Another proposal calls for pre-trade disclosure: Before you do a trade you have to tell the market what your planning to do, and how you are planning to do it. That kind of disclosure kills the trade, and kills the market.

There is another suggestion that regulators are requiring all derivative trades to be traded through clearing houses. We like clearing houses. Clearing OTC derivatives through clearinghouses makes an enormous amount of sense. But the regulators do not know what they are talking about, and they have no idea about the financial requirements clearinghouses will need in order to assure financial viability of markets that are loaded up with OTC derivatives.

Additionally, they keep talking about requiring "all standardized derivatives transactions" be cleared. Anyone who has worked on Wall Street in derivatives can assure you that very few OTC derivative trades are "standard." These typically are custom trades. One assumes that bank lobbyists will assure that the final regulations will have enough vagueness of definition to allow most banks to declare most derivatives to be custom products and thus not covered by any guidelines related to disclosure or clearing.

Our View

Our view has always been that effective regulations, intelligent regulations are important. CPM Group has been a proponent of regulating the OTC derivatives market since its founding in June 1986. However, we have a minimalist view of how they should be regulated.

We also favor private sector programs within the encouragement of governments that provide educational services to market users.

Derivatives Regulations

As mentioned earlier, in 2002 there was a round of derivatives market scandals that reflected, among other things, how corporations and institutional investors were being sold derivative products by banks and brokers that the buyers did not understand, and on which the banks and brokers had failed to accurately disclose the risk profiles.

We trade for our clients, but we never trade with our clients or against our clients. We will structure a derivative for our client that wants to hedge or invest in a commodity, and we will competitively price that in the banking and brokerage market. When we deal with derivative transactions, we virtually always give them a table and a

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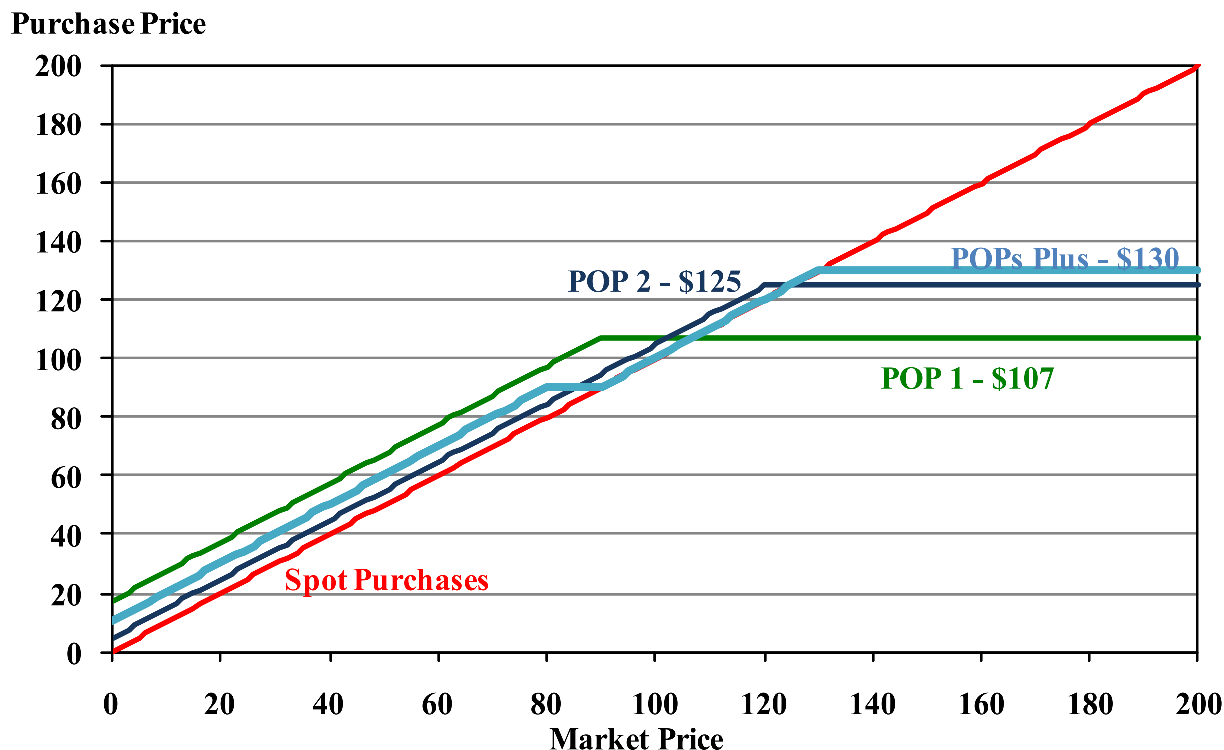
chart, similar to those shown on the following pages, showing the price consequences of that derivative under various market scenarios.

They clearly show the consumer of these derivatives what happens to its profitability, its credit worthiness, and its risks and reward benefits under various price and interest rate circumstances.

Governments keep talking about regulating the derivative markets, suggesting cumbersome, unworkable, and ineffective regulations. Rather than such inappropriate regulations, an alternative would be simply requiring that every time a derivative was offered to a counterparty by a bank or a broker that offer had a chart, table, and a brief text box outlining what the product is, and what it does to the client's pricing and credit worthiness under different price and interest rate circumstances.

Consumer Hedge for December 2012: Participatory Option Program



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Consumer Oil Hedges

Comparative Profitability

		POP 1		POP 2		POPs Plus	
Apr 11 Price	$97.88		$/Barrel		$/Barrel		$/Barrel
Dec 12 Price	$101.97	Max Price Paid	107.46	Max Price Paid	124.79	Max Price Paid	130.32
		Forego	17.46	Forego	4.79	Market Price to	90.32
		Buy back in at	90.00	Buy back in at	120.00	Forego	10.32
						Buy back in at	80.00
Price	Spot Sales	Participatory Option (POP 1)	Profitability Comparable To Spot	Participatory Option (POP 2)	Profitability Comparable To Spot	Participatory Option (POPs Plus)	Profitability Comparable To Spot
$0.00	$0.00	$17.46	-$17.46	$4.79	-$4.79	$10.32	-$10.32
$10.00	$10.00	$27.46	-$17.46	$14.79	-$4.79	$20.32	-$10.32
$20.00	$20.00	$37.46	-$17.46	$24.79	-$4.79	$30.32	-$10.32
$30.00	$30.00	$47.46	-$17.46	$34.79	-$4.79	$40.32	-$10.32
$40.00	$40.00	$57.46	-$17.46	$44.79	-$4.79	$50.32	-$10.32
$50.00	$50.00	$67.46	-$17.46	$54.79	-$4.79	$60.32	-$10.32
$60.00	$60.00	$77.46	-$17.46	$64.79	-$4.79	$70.32	-$10.32
$70.00	$70.00	$87.46	-$17.46	$74.79	-$4.79	$80.32	-$10.32
$80.00	$80.00	$97.46	-$17.46	$84.79	-$4.79	$90.32	-$10.32
$90.00	$90.00	$107.46	-$17.46	$94.79	-$4.79	$90.32	-$0.32
$100.00	$100.00	$107.46	-$7.46	$104.79	-$4.79	$100.32	-$0.32
$110.00	$110.00	$107.46	$2.54	$114.79	-$4.79	$110.32	-$0.32
$120.00	$120.00	$107.46	$12.54	$124.79	-$4.79	$120.32	-$0.32
$130.00	$130.00	$107.46	$22.54	$124.79	$5.21	$130.32	-$0.32
$140.00	$140.00	$107.46	$32.54	$124.79	$15.21	$130.32	$9.68
$150.00	$150.00	$107.46	$42.54	$124.79	$25.21	$130.32	$19.68
$160.00	$160.00	$107.46	$52.54	$124.79	$35.21	$130.32	$29.68
$170.00	$170.00	$107.46	$62.54	$124.79	$45.21	$130.32	$39.68
$180.00	$180.00	$107.46	$72.54	$124.79	$55.21	$130.32	$49.68
$190.00	$190.00	$107.46	$82.54	$124.79	$65.21	$130.32	$59.68
$200.00	$200.00	$107.46	$92.54	$124.79	$75.21	$130.32	$69.68