

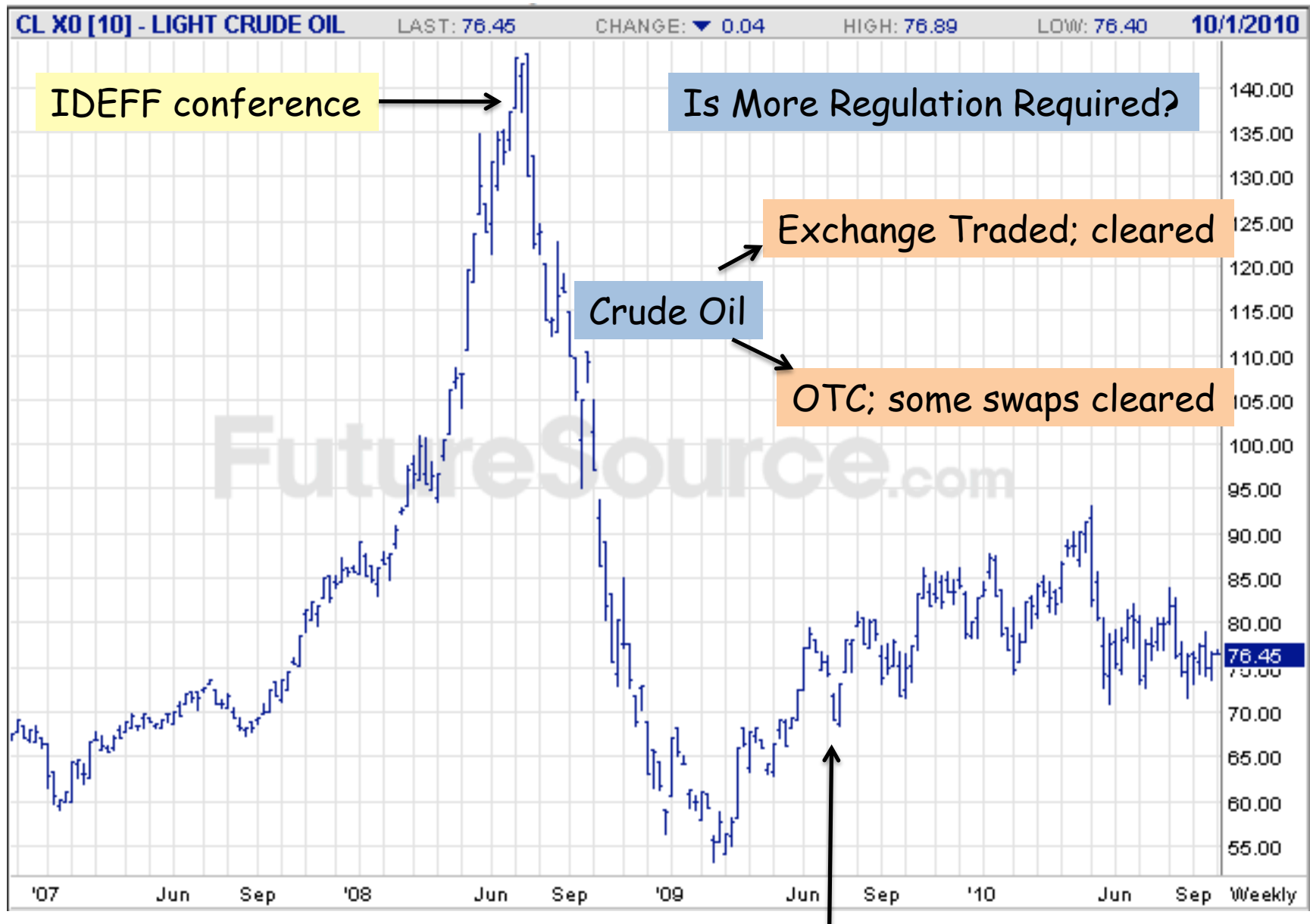
*Regulation-Supervision of Commodity Derivatives  
(futures, forwards, options & swaps).*

Colin Carter

University of California, Davis

September 28, 2010





"Oil Prices Need Government Supervision"

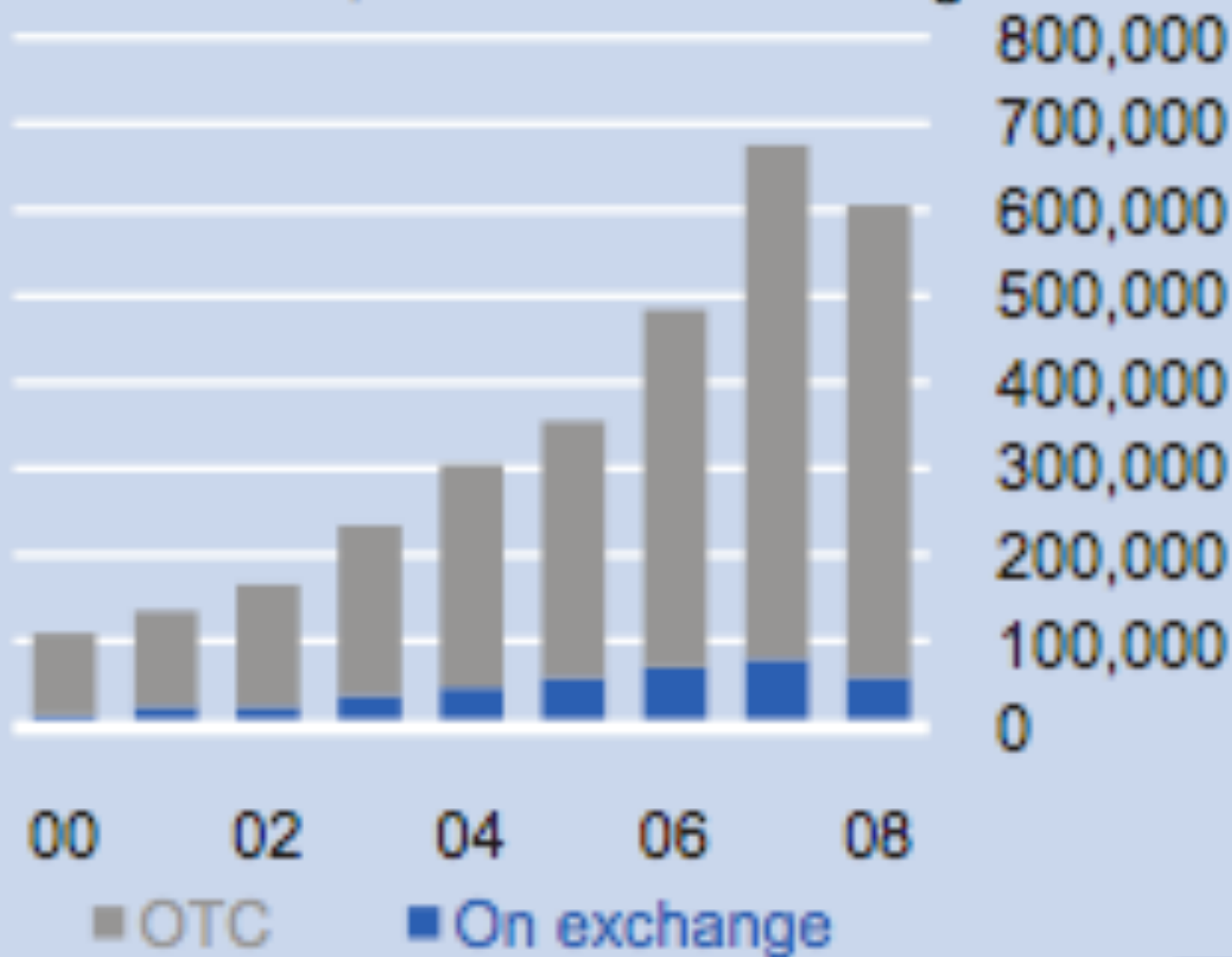
PM [Gordon Brown](#) & Pres. [Nicolas Sarkozy](#), *Wall St Journal*, July 8, 2009

## Over-the-Counter (OTC) Derivatives

- OTC markets have grown substantially & have an important role in our financial system, including the commodity markets.
- Sep '09 G20 leaders decided that standardized OTC derivatives should be cleared through central counterparties (CCPs).
- OTC derivatives offer certain advantages over exchange traded instruments, but often have no central counter-party because OTC derivatives are not traded on an exchange.

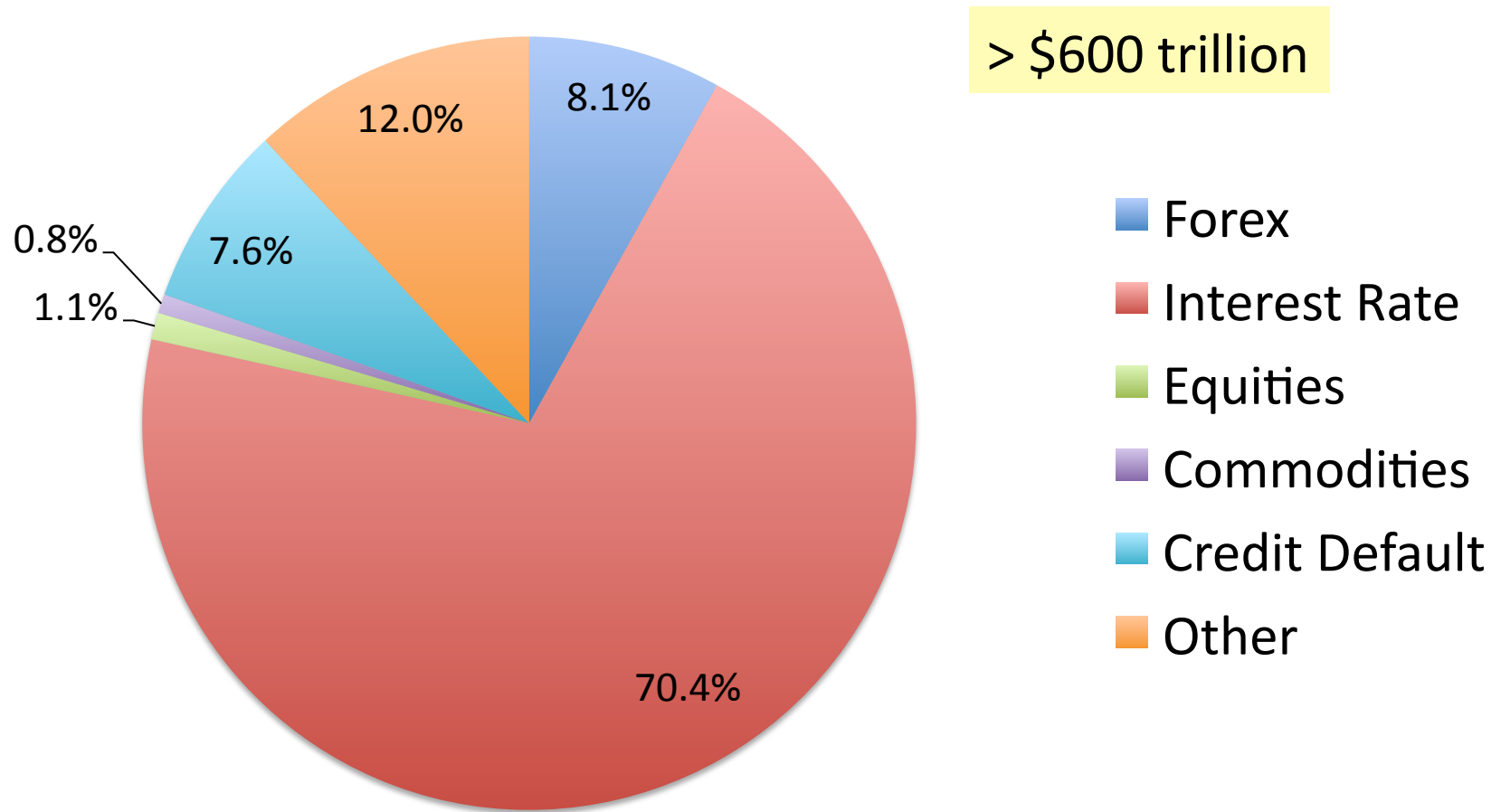
# Global derivatives market

Notional amounts outstanding, USD bn, annual data, OTC vs. on exchange



Source: BIS

# OTC Derivatives By Category



Source: Bank for International Settlements

W Z0 [10] - WHEAT (DAY)

LAST: 720'0

CHANGE: 22'6

HIGH: 722'0

LOW: 700'0

9/24/2010

IDEFF conference



Agric commodities swap trading increased with rise of index & hedge fund trading

FutureSource.com

1020'0  
1000'0  
980'0  
960'0  
940'0  
920'0  
900'0  
880'0  
860'0  
840'0  
820'0  
800'0  
780'0  
760'0  
740'0  
720'0  
700'0  
680'0  
660'0  
640'0  
620'0  
600'0  
580'0  
560'0  
540'0  
520'0  
500'0  
480'0

'07 Jun Sep '08 Jun Sep '09 Jun Sep '10 Jun Sep Weekly

Russian export ban



C Z0 [10] - CORN (DAY)

LAST: 516'0

CHANGE: ▼ 5'6

HIGH: 522'0

LOW: 516'0

10/1/2010

Agric commodity prices are increasing again; some are blaming speculators

FutureSource.com





India export restriction



## Financial Crisis & Regulatory Spillover into Commodities (e.g. energy, metals, agricultural commodities)

- 2nd anniv. of the collapse of Lehman Brothers (*f. 1850*).
- Crisis has brought on new **Derivatives Legislation** in the US & (similar) proposed legislation in the EU;
- **Dodd-Frank** financial reform bill became U.S. law in July'10

### Recent Headlines:

- **"EU to Rein in Commodity Speculation"** *Finan Times 21/9/10*
- **"EU unveils crackdown on derivatives"** *Finan Times 15/9/10*
- **"Dodd-Frank Will Fail"** *Forbes 17/9/10*

## Overview of U.S. Derivatives Legislation

- Commodity Futures Modernization Act (2000): **more OTC derivatives the better** & no need to regulate (Greenspan, Summers, SEC & CFTC). - "Enron Loophole"
- That view has changed dramatically. Dodd-Frank requires exchange trading & clearing for most standardized swaps & could also impose new regs. on non-standard swaps.

## Implications:

- Regulations aims to reduce risk; but costs will increase for many financial entities & their customers.
- Hedgers **may** have some exemptions (e.g. airlines, electric cos) but their costs & risks could increase.
- More gov't regulation may concentrate risks.

## Dodd - Frank

- **Dodd-Frank**: most sweeping U.S. financial regulatory reforms since the Great Depression -provides a very general regulatory framework.
- The Act ensures swap traders will be subject to increased regulatory scrutiny & SEC & CFTC enforcement action.
- A key question is the extent to which the CFTC & SEC will have enforcement power over non-US market participants.
- CFTC may have jurisdiction over some foreign swaps if the trading has an effect on US commerce/ markets.
- Most of the substance of the new regulations will come from the **upcoming rulemakings** (i.e., "devil is in the details).

## Clearing Requirements

- If it's OTC & not spot, Dodd-Frank calls it a swap.
- Clearinghouses are entities responsible for settling trading accounts. CME has world's largest clearinghouse.
- Under Dodd-Frank regulators must determine which type of swaps must be cleared in the future.
- Most standardized swaps may require clearing while more complex swaps could continue to trade bilaterally, but be publicly reported & be subject to margin requirements.
- Will the regulatory agencies leave considerable discretion to the registered clearinghouses (controlled by the largest banks) ?
- Will clearing solve all the "derivative problems"?

## Position Limits

- Position limits may be imposed on any swaps that provide a “significant price discovery function.”
- How will regulators set the position limits?
- How will the exemption for hedging be implemented?

## Issues

- Still unclear which Hedge Funds & Financial Firms will fall under new derivative rules.
- Concentration of large banks & their control of clearinghouses could lead to a "real risk that we're going to end up right where we started."
- New derivative rules could push some firms to shift their derivatives operations overseas & use foreign banks.

## Proposed EU Regulation

- Quite Similar to Dodd-Frank.
- Draft legislation designed to reduce risks posed by **over-the-counter** derivatives by moving transactions to **clearing houses** & encouraging greater standardization of products.
- May exempt firms carrying out commercial hedging.
- Affects Banks, Hedgers, Hedge Funds, & Financial Firms.

# Price CME & ICE Stock





## Conclusions

- New laws are responding to a crisis & to some extent are a political response to a populist backlash against markets.
- Commodity Markets have been caught up in financial reforms; do they need more government regulation?
- Impact on relatively small market participants raises competition issues.
- **Risks & costs may rise** for many hedgers & these costs will be passed on to consumers.
- These new laws may or may not improve the efficiency, stability, & functioning of the financial markets.