Securities Regulation Daily Wrap Up, CFTC NEWS AND SPEECHES—Crash in crude oil futures and negative pricing triggers Commissioner Berkovitz' call for CFTC review, (May 8, 2020)

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By Brad Rosen, J.D.

At the Commodity Future Trading Commission's recent Energy and Environmental Markets Advisory Committee meeting, Commissioner Dan Berkovitz called for the agency's close examination of market activities leading to unprecedented falling prices in the May crude oil contract.

Commissioner Dan Berkovitz led off the recent meeting of the CFTC's Energy and Environmental Markets Advisory Committee (EEMAC), by indicating he would address what was on many peoples' mind. That would be the extraordinary activity in energy markets, and the unprecedented collapse in the price of the May crude oil futures contract, which fell from $17.73 per barrel at the market open to a closing settlement price of negative $37.63 per barrel on April 20, 2020. In the last 20 minutes of trading, buying was scarce as the price dropped approximately $40 per barrel. Berkovitz declared, "We must carefully examine the trading data and market participant activities on and around April 20th. A critical question that both the Commission and the CME must answer is the extent to which trading in WTI on that date resulted from unique circumstances or actions, or reflects structural issues with the contract that may persist or recur in the future."

Price divergences—past and future. Berkovitz observed "a futures contract that is disconnected from the physical market cannot effectively serve to discover prices or manage price risks arising from the use of the commodity." Accordingly, he implored that the CFTC must determine the causes of this unprecedented price movement and divergence from physical markets, and further called for the CFTC to work with the CME "to ensure that trading in upcoming WTI expirations is orderly, supports convergence, and reflects supply and demand in the physical market, while maintaining sufficient liquidity for commercial market participants."

Berkovitz also opined that if convergence issues persist, the EEMAC can play an important role in advising the Commission on how to achieve these objectives. Notably, the Commissioner sees a high probability that the supply, demand, and storage conditions that were present during trading in the May spot month will persist through the upcoming weeks and into the spot month for the June WTI futures contract.

A spotlight on the CFTC's proposed position limit rule. While the recent chaos in the energy markets loomed in the background and informed some of the discussion, the remote EMMAC meeting, held in accordance with agency's COVID-19 pandemic protocols, centered around the CFTC's pending proposed position limit rule. The day's agenda included one panel on the proposed position limits for spot months, single month, and all-months-combined. The second panel examined the proposed bona fide hedge exemptions from those position limits and related procedures.

There was general support for the proposed position limit rule from most of the panels' participants, who largely represented industry groups, end users, and various exchanges, while there were some calls for greater clarity or further regulatory relief. However, some of the participants who advocated for consumers or the public interest expressed their steadfast disagreement with the proposal.

A core dispute. Associate EMMAC member Tyson Slocum, of Public Citizen, a self-described nonprofit consumer advocacy organization that champions the public interest, expressed his deep concern that the current proposed rule permits for-profit exchanges with the authority to determine non-enumerated hedge exemptions in the first instance. Slocum asserted that outsourcing this frontline regulatory activity to exchanges would create irresolvable conflicts of interest. He noted that exchanges are in the business of trading. Granting exemption would inevitably result in more trading, more business, and more profits. Slocum also conveyed his lack of faith in internally enforced firewalls, as claimed by exchanges, and stated his strong preference for unbiased CFTC staff to be performing these functions.

Fellow Associate member James Allison took issue with nearly all of Slocum's assertions. He contended that exchanges have the best understanding of their own markets and have relevant information at hand to make these exemption determinations. He also noted that within each exchange there is an effective separation between the business and compliance functions. Lastly, he asserted that market participants want effective risk management and do not want the intemperate granting of exemptions. "It is in the exchanges interest to do it right", he proclaimed.

Chairman Tarbert and Commissioner Quintenz weigh in. Chairman Heath Tarbert, in his comments, identified the essential balance the proposed rule seeks to address. He stated, "First, our limits should be high enough to permit liquidity provision and a healthy level of speculative trading. But second, the limits should be low enough to prevent that speculative trading from disrupting delivery, effecting a corner or squeeze, or otherwise causing excessive volatility." The chairman also observed, "We must also be careful that our limits only apply to speculative activity. In other words, *speculative* position limits must not apply to bona fide hedging activity. In this respect, position limits is the rare instance where the exception is as important as the rule itself."

Commissioner Quintenz, while noting that no proposal is perfect, expressed his general support for the proposed rule noting that, "it represented a significant improvement over prior proposals and elegantly balanced the Commission's policy interests of promoting liquidity, deterring manipulation, squeezes, and corners, and ensuring the price discovery function of the underlying cash market is not disrupted."

Quintenz also noted his interest in the proposal's exchange-centered process that will be used to determine non-enumerated bona fide hedge exemption requests. He shared an observation that exchanges have long granted bona fide hedging exemptions in those markets where there are no federal limits as part of their stewardship of their own position limits regimes.

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