

Impending US Regulations and Their Effects on the Commodity/Energy Markets

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Macroeconomic Effects

US House of Reps. Passed **Dodd-Frank Act (DFA)** on Dec. 1, 2009

Similar Bill Passed the US Senate

Reconciliation Bill Passed Both Houses

President Obama Signed Into Law on July 7, 2010

- Miller/Perlmutter/Lincoln Amendment: OTC Derivatives To Trade Through Clearing Houses where possible.
- Kanjorski Amendment: **Requires SIFI's (Systemically Important Financial Institutions – more than \$10 billion in assets) to file an orderly way to liquidate (i.e. a “living will”). All such plans must be filed with FSOB (Financial Stability Oversight Council)**

Macroeconomic Effects

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- **DFA = 385,361 words**
- **Glass-Steagall Act = 43,000 words**
- **DFA policy multiplier = 10X 385,361 = 3,853,610 words = approx. 5 times the size of the Bible.**

Macroeconomic Effects

- **DFA Requires OTC Derivatives To Be Cleared Through Clearing Houses Where Possible**
- **Requires Non-Cleared OTC Derivatives To Have Bilateral Margin**
- **Requires the CFTC To Regulate OTC Commodity Derivatives**

Macroeconomic Effects

- **“The Volker Rule” covering US banks and their non-US affiliates, and firms owning US banks (July, 2012):**
 - Prohibited from proprietary trading.
 - Investments in hedge funds or private equity firms:
 - Restricted to maximum of 3% of Tier 1 capital.
 - Restricted to no more than 3% of any one hedge fund or private equity firm.

	Tier 1 Capital	3% of Tier 1
	(in billions)	(in billions)
Bank of America	155	4.7
JPMorgan	131	3.9
Citi	119	3.6
Goldman Sachs	68	2.1
Morgan Stanley	49	1.5

Based on Q1-2010 financial statements

Macroeconomic Effects

- **There are exemptions from “The Volker Rule”:**
 - **Example: FDIC institutions can engage in proprietary trading in IR, FX, Gold, Silver, and cleared Credit Default Swaps**

Dismantling SIFI's

- **Estimates of firms falling into this “too big to fail” category:**
 - **Some likely candidates:**
 - BofA
 - Wells Fargo
 - Citi
 - Goldman Sachs
 - AIG
 - Morgan Stanley
 - JP Morgan Chase
 - Prudential
 - Allstate
- **The Big Question: If a SIFI is dismantled, would an independent spin-off commodity entity be able to get the same credit limits from clearing houses and counterparts? If not, market liquidity would be negatively affected.**

Proprietary OTC Trading To Clear Through Clearing Houses

- **Which OTC derivatives?**
 - Interest Rate Swaps?
 - Credit Default Swaps (YES)
 - Exotic derivatives like barriers, digitals, lookbacks, compound options, etc.?
 - ABS?
 - Commodity options (probably most vanilla ones but this is unclear at this time)?
- **The Big Questions:**
 - How much time and effort for Clearing Houses to upgrade their software?
 - How much time and effort for financial firms to interface with these upgrades?
 - How much time and effort to train staff to use the upgraded software?
 - Which mathematical models will be added to existing Clearing House risk/collateral systems (SPAN for example) for all the new OTC derivatives?

Proprietary OTC Trading To Have Bilateral Margin If Not Cleared

- **Which OTC derivatives?**
 - All of them
- **The Big Questions:**
 - How much time and effort for firms to upgrade their systems?
 - Who will calculate the margin amounts and how?
 - Where will it be deposited?
 - Will it satisfy the regulators?

Microeconomic Effects

(Specific To Commodity/Energy Markets)

- Title 3 of the DFA Establishes CFTC Regulatory Authority Over **Commodity/Energy OTC Markets**
- CFTC Will Now Begin the Very Difficult Process of Writing the New Rules to Cover OTC Commodity Trading – This Will Take Years To Accomplish
 - How will the CFTC incorporate position limits on cleared and non-cleared OTC derivatives into the existing position limits scheme for exchange traded derivatives?
 - One of the issues: Using delta equivalent positions will work for vanilla options but will not for some exotics whose Greeks behave bizarrely (example: barrier options with in-the-money barriers).

Microeconomic Effects

(Position Limits on Exchanges Specific To Energy Markets)

- CFTC Held Series Of Hearings On “Spec Limit” Rules From July, 2009 through January, 2010
- Proposed “Spec Limit” Rules Approved by CFTC on January 14 and Published in Federal Register on January 26
- 90 Day Public Comment Period Ended April 26
- CFTC Approved the Published Version

CFTC “Spec Limit” Hearings-Energy

- Attendees: Swap Dealers/Banks, Hedge Funds, Index Funds, Airline Industry, Trucking Industry, Wholesale Gas/Oil Supply Industry, Commodity Exchanges, Public Interest Group, Academics, Etc.
- Exchanges:
 - CME: Exchanges should set position limits
 - ICE: CFTC should set position limits
- Passive Investors:
 - Index Funds (US Nat Gas and US Oil): “Speculators did not cause the volatility. We do not need position limits”.
 - Gresham Inv. Mgmt. (Henry Jarecki): No limits needed – business is strictly pass through with no leverage.

CFTC “Spec Limit” Hearings-Energy

- Trucking Assoc:
 - Too much speculation in market – need position limits – set by CFTC.
- FIA:
 - Strong supporter of position limits
- Public Citizen (Tyler Slocum):
 - Strong supporter of position limits – speculation-induced volatility hurt retail households

CFTC “Spec Limit” Hearings-Energy

- Swap Dealers/Banks:
 - JP Morgan: Position Limits OK but need exemption for trades that hedge deals done with commercial end users.
 - Goldman Sachs: Same as above.
 - Morgan Stanley: Same as above.

CFTC “Spec Limit” Hearings-Energy

- Academics:
 - U. of Calgary Prof: Speculation did not cause energy volatility. Natural events caused it: European change to clean diesel and a lack of refining capacity in Europe caused a price rise and a natural inclination of US refiners to export to Europe – caused a shortage here which spilled over into all energy markets.
 - U. of Maryland Prof: Speculators controlled over 35% of the market. This is excessive and definitely caused the run up in prices in 2008-2009.

CFTC “Spec Limit” Hearings-Energy

- **Consensus Among the CFTC Commissioners:**
 - CFTC should set aggregated energy position limits for spot months, forward months, All Months Combined (AMC).
 - Exemptions will be granted to commercial users/hedgers (must provide evidence of natural business).
 - Limited exemptions should be granted to Swap Dealers for hedging OTC trades done with commercial end users.
 - Position Limits for metals will be addressed in future hearings.
 - The DFA requires the CFTC to set limits on OTC positions and this will be done in the next few years.

CFTC Proposed Spec Limit Rules-Energy

- Aggregated Across All Exchanges:
 - Spot Month:
 - 25% of the estimated deliverable supply
 - 125% if holding cash settled contracts only (i.e. no physically settled spot month contracts)
 - All Months Combined (AMC):
 - 10% of the first 25,000 contract of open interest plus 2.5% of open interest over 25,000 contracts.
 - Single Forward Month:
 - $\frac{2}{3}$ of the AMC limit.

CFTC Proposed Spec Limit Rules-Energy

- Changes from current practice:
 - Set at ownership level – no disaggregation allowed for independent account managers.
 - Aggregated across all reporting entities (currently NYMEX and ICE)
 - Formulaic: reset annually basis prior year's average open interest rather than waiting for a CFTC intervention.

CFTC Proposed Spec Limit Rules-Energy

- Exemptions:

- Hedging Exemption: holders of inventory or anticipated purchase or sales of physical commodity. Exemptions up to the level of their demonstrated needs.
- Limited risk management exemption for swap dealers (for exchange trades that hedge the risk of their deals with commercial end users). Capped at 2 times the otherwise applicable position limit (spot month, single forward month, or AMC).

CFTC Proposed Spec Limit Rules-Energy

- **Contracts Covered:**
 - Henry Hub natural gas
 - Light Sweet Crude (WTI)
 - New York Harbor No 2 heating oil
 - New York Harbor gasoline blendstock
- NOTE: Both physically and cash settled contracts are covered.

All Months Combined Referenced Energy Commodity Speculative Positions Under the Proposal (Historical)

Referenced Energy Contract	Reporting Market	Physical or Cash Settled	Effective Period if the proposed regulations were in effect								
			3/2001 - 2/2002	3/2002 - 2/2003	3/2003 - 2/2004	3/2004 - 2/2005	3/2005 - 2/2006	3/2006 - 2/2007	3/2007 - 2/2008	3/2008 - 2/2009	3/2009 - 2/2010
Light Sweet Crude Oil	NYMEX	P	17,800	17,400	21,500	22,500	28,700	36,700	50,100	74,700	98,100
		C			7,900	8,300	10,800	14,000	50,100	74,700	98,100
	Aggregate Level		17,800	17,400	21,500	22,500	28,700	36,700	50,100	74,700	98,100
New York Harbor Gasoline Blendstock	NYMEX	P	5,000	5,200	5,100	5,000	6,000	6,300	6,000	7,500	9,000
		C							5,000	5,000	8,800
	Aggregate Level*		4,600	5,200	5,100	4,700	6,000	6,300	6,000	7,500	9,000
New York Harbor No. 2 Heating Oil	NYMEX	P	6,400	6,000	6,200	5,900	7,300	7,400	7,500	8,700	10,100
		C				5,000	5,000	5,000	5,000	8,700	10,100
	Aggregate Level		6,400	6,000	6,200	5,900	7,300	7,400	7,500	8,700	10,100
Henry Hub Natural Gas	NYMEX	P	14,700	17,100	23,100	19,900	22,900	40,200	76,500	121,000	132,700
		C			8,500	19,900	22,900	40,200	76,500	121,000	132,700
	ICE**	C							121,000	132,700	
	Aggregate Level		14,700	17,100	23,100	19,900	22,900	40,200	76,500	121,000	132,700

* The Aggregate Level is less than the class level for 3/2001-2/2002 and again in 3/2004-2/2005 because the proposed regulation does not provide a *de minimus* level for the aggregate. Historically there was a low level of aggregate open interest in this referenced energy contract.

**ICE began reporting open interest to the CFTC on October 2007.

All Months Combined Referenced Energy Commodity Speculative Positions
Under the Proposal (Prospective)

Referenced Energy Contract	Reporting Market	Physical or Cash Settled	3/2010 - 2/2011
Light Sweet Crude Oil	NYMEX	P	98,200
		C	98,200
	Aggregate Level		98,200
New York Harbor Gasoline Blendstock	NYMEX	P	8,900
		C	8,900
	Aggregate Level		8,900
New York Harbor No. 2 Heating Oil	NYMEX	P	13,100
		C	13,100
	Aggregate Level		13,100
Henry Hub Natural Gas	NYMEX	P	117,300
		C	117,300
	ICE	C	117,300
	Aggregate Level		117,300

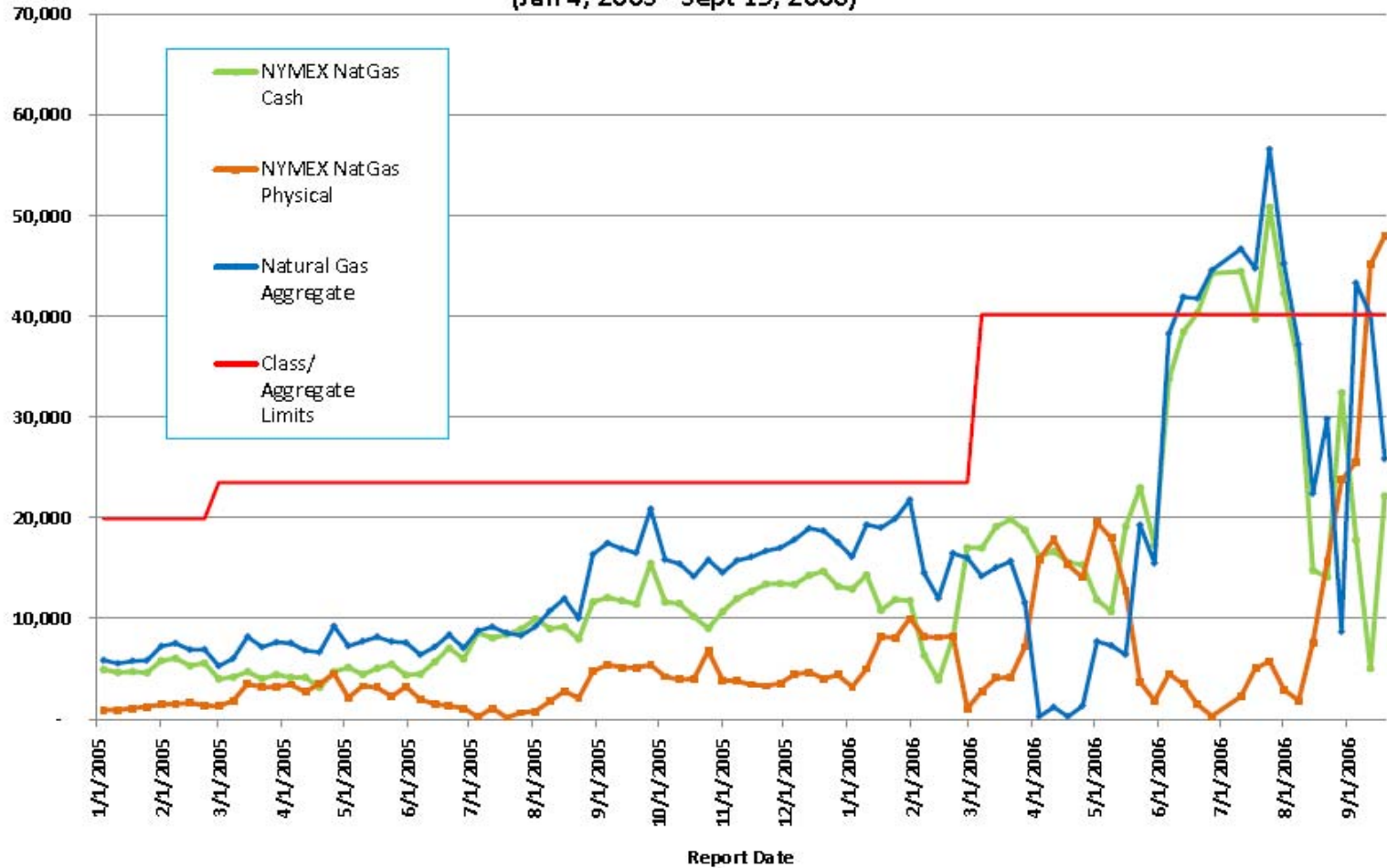
Proposed AMC Limits

From Jan. 1, 2008 to Dec. 31, 2009 (Tuesdays only)

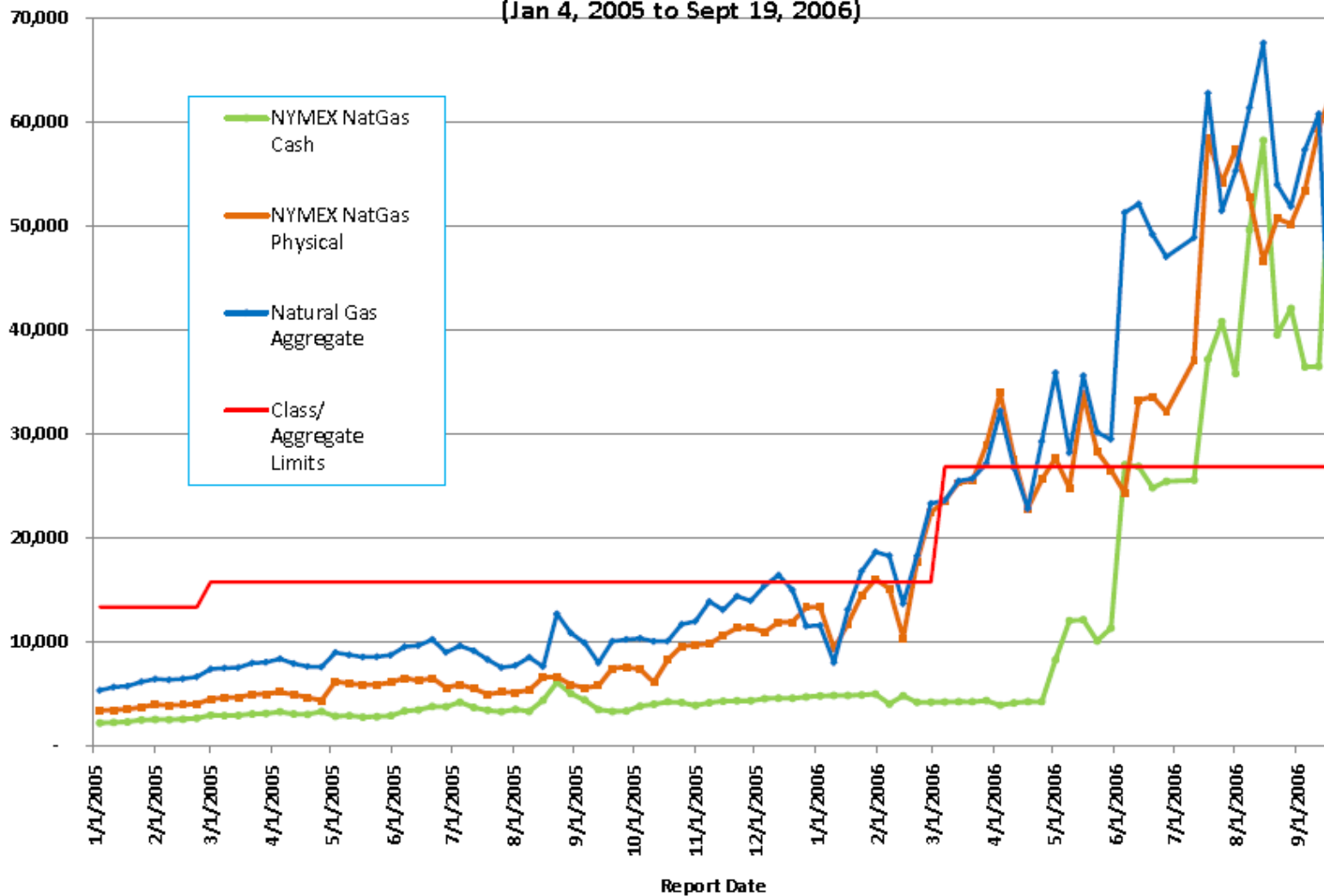
Commodity Type	Maximum Number of Owners Affected in One Day	Number of Unique Owners during the Period
Crude Oil	2	3
Gasoline	9	19
Heating Oil	7	16
Natural Gas	1	1

23 Total Unique Owners

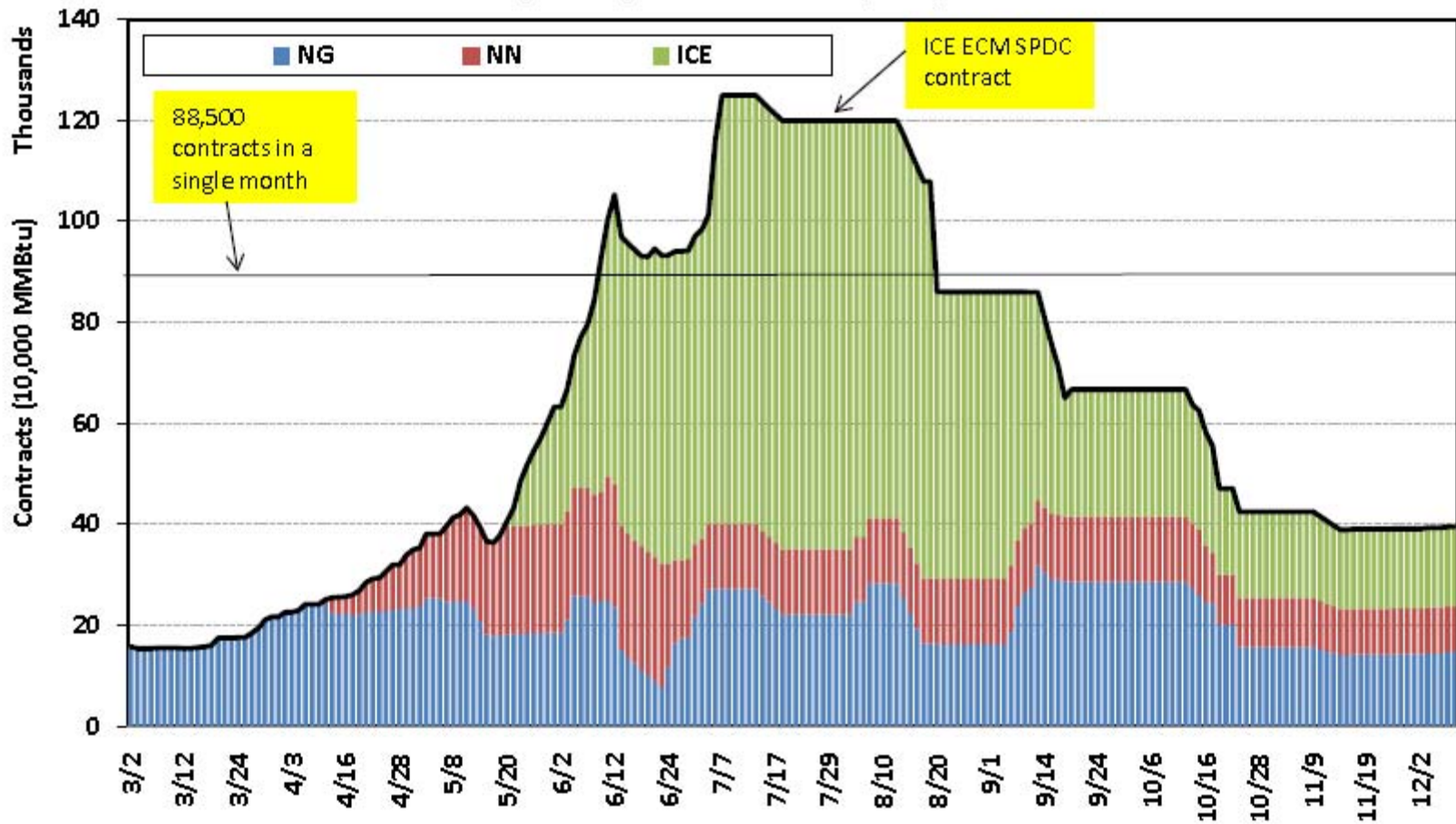
**Amaranth's All-Months-Combined Net Position in Natural Gas
and Proposed Speculative Limits
(Jan 4, 2005 - Sept 19, 2006)**



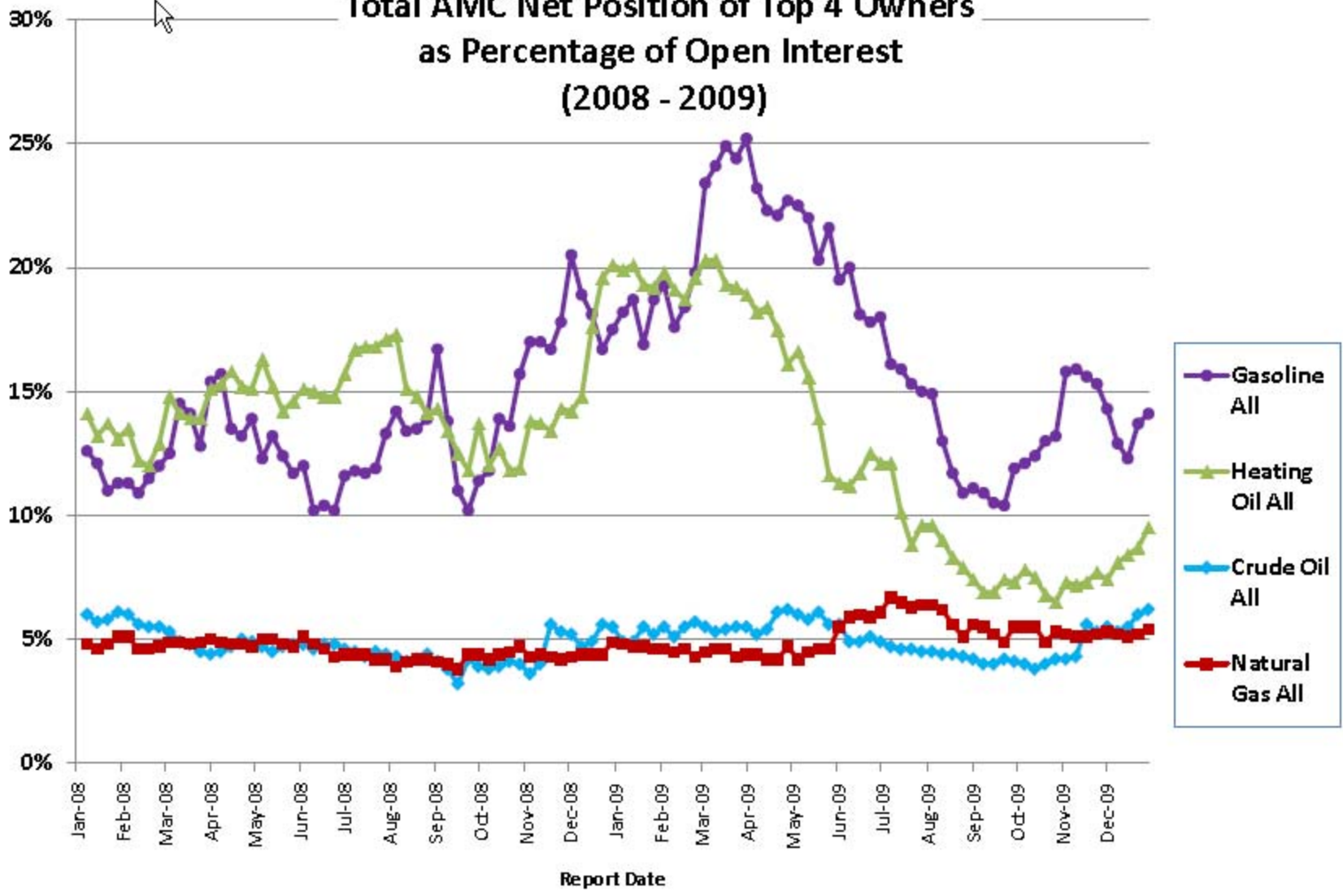
**Amaranth's Single Month Net Position in Natural Gas
and Proposed Speculative Limits
(Jan 4, 2005 to Sept 19, 2006)**



US Natural Gas Fund Positions and Proposed Speculative Limit (March 2, 2009 - December 9, 2009)



Total AMC Net Position of Top 4 Owners as Percentage of Open Interest (2008 - 2009)



CFTC “Spec Limit” Hearing-Metals

March 25, 2010

- Attendees: Individual Investors, Wholesale Industry, Commodity Exchanges, Passive Long Investors, Metals Researchers, Etc.
- Exchanges:
 - CME: Exchanges should set position limits
- **Passive Investors:**
 - **(Henry Jarecki): No limits needed – business is strictly pass through with no leverage.**
- **Individual Investors:**
 - **Position limits are definitely necessary but aggregated across all markets, not by individual market. This must also include the OTC market.**
 - **ETF’s on Platinum group metals are dangerous to our national security – these are strategic metals. Why is SEC in charge of these instead of CFTC?**

Financial Institution Compensation

- Compensation incentives misalign employees goals with prudent corporate goals.
- Currently most compensation is based on creation of short-term GAAP earnings.
- Compensation should instead be based on risk-adjusted GAAP earnings.
 - Example:
 - In 2010, energy trader A earned USD 5,000,000 with an average daily market VaR of USD 50,000,000.
 - In 2010, energy trader B earned USD 2,000,000 with an average daily market VaR of USD 5,000,000.
 - Currently, Trader A is a hero and Trader B is a bum.
 - In the new regime, trader A is the bum and trader B is the hero.