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Compliance in Commodity Derivatives Markets

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On June 21 and 22, lawyers, compliance professionals and commodity traders convened in Houston to discuss current compliance matters and the state of commodity markets, with the focus on energy commodities as well as carbon and environmental products. The following themes emerged from the panels with speakers from private industry, consultancies and regulators, such as the Commodity Futures Trading Commission (“CFTC”), the Federal Energy Regulatory Commission (“FERC”) and the National Futures Association (“NFA”).

1. Enforcement

In 2021 and 2022, the industry experienced a record number of enforcement actions from the CFTC and the NFA, with record settlement amounts. Enforcement focused on fraud and manipulation, Foreign Corrupt Practices Act (“FCPA”)-like enforcement and misappropriation of material non-public information in commodity markets, failure to register in appropriate capacity and substantive regulatory violations, such as reporting. Importantly, in addition to enforcement from traditional market regulators, the Department of Justice (“DOJ”) has been much more actively involved in commodity derivatives market-related enforcement traditionally relegated to the CFTC, FERC, NFA and the Securities and Exchange Commission (“SEC”).

2. Commodity Digital Assets

Application of financial engineering is rapidly spreading beyond cryptocurrencies to physical commodity markets. Blockchain is increasingly used to track commodity transactions and the non-fungible tokens (“NFTs”), and other smart contracts are helping end users to trade commodities and ensure a more efficient and accurate delivery. These applications are at the nexus of the SEC’s, CFTC’s and FERC’s jurisdictional reach, with a significant regularity overlap. DOJ is likely to continue being actively involved in policing these markets under its wire fraud authorities, while market regulators clarify their regulatory reach.

3. ESG and Environmental Commodities

Environmental, social and governance ("ESG") initiatives in commodity markets are at the forefront of commodity trading strategies – with the emphasis on climate change mitigation and the trading of environmental commodities. Both compliance and voluntary markets in carbon mitigation are rapidly developing under local state authorities (such as CCA and RGGI) as well as commonly accepted voluntary industry standards and registries (such as ACR, CAR and Verra). The CFTC recently published a request for information ("RFI") to assess the scope of the markets and its likely jurisdictional reach.

4. Market Volatility

The war in Ukraine and the unprecedented global sanctions imposed on Russia, which together with Ukraine are the world's largest suppliers of many critical commodities, such as natural gas, crude oil, agricultural commodities and fertilizers, have severely strained commodity markets and are likely to even further disrupt commodity and commodity derivatives markets. Market volatility is causing drastically higher and more frequent margin calls, which increase the costs of trading; as a result, many commodity contracts have moved from the exchanges to the OTC markets. These trends call for enhanced compliance supervision on both the exchange and clearing side of the markets, and the end user and market intermediary side.

5. Enhanced Compliance

Discussions during the FIA conference demonstrated that the category of unregulated commodity trader no longer exists, and there are either registered or unregistered market participants – but all are regulated and all are subject to potential CFTC, SEC, FERC, NFA or DOJ enforcement. This calls for greater assessment of operational, regularity and compliance risks and a design of more comprehensive compliance policies and procedures as well as business continuity and disaster recovery procedures.