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UNPRECEDENTED DROP IN PRICE OF WTI CRUDE OIL FUTURES CONTRACT – WHAT TO EXPECT FROM CME AND CFTC IN RESPONSE

In an event that is unprecedented in recent memory, on Monday, April 20, the price of a soon-to-expire crude oil futures contract fell over $50 in a single day of trading, settling at a deeply negative price. Traders should be prepared for the possibility that the exchange or the U.S. government will invoke seldom-used emergency powers to affect trading, conditions of delivery, or even settlement price. And in the longer term, both the exchange and the U.S. government can be expected to closely scrutinize trading in the contract, increasing the risk that penalties will be levied against traders found to have violated exchange rules or the law.

The May 2020 WTI Crude contract, which expires on Tuesday, April 21, opened on April 20 at a price of $17.73 per barrel before plunging to a settlement price of negative $37.63. WTI crude futures are traded on the New York Mercantile Exchange, an exchange operated by CME Group ("CME"). The price of WTI crude futures contracts for other months, including the heavily traded June 2020 contract, did not decrease to nearly the same extent as the May 2020 contract, meaning that as the price of the May 2020 contract decreased, its spread to other contracts widened greatly. The fall in prices of the May 2020 WTI futures contract appears to have resulted from concerns regarding crude oil storage capacity in Cushing, Oklahoma, the location at which buyers must take delivery under the terms of the contract. As a result of the dramatic price movement, and the widening spread to other contracts, traders with long positions will likely be facing very large and uneconomic margin calls.

Below, we discuss potential short-term responses by the CME and the United States Commodity Futures Trading Commission ("CFTC"), as well as potential medium-term responses by the CME, CFTC and the United States Department of Justice ("DOJ"). In the short term, the CME and the CFTC have a range of emergency powers at their disposal that they will likely consider invoking. In the slightly longer term, there is a substantial likelihood that trading will be scrutinized by the CME, CFTC and DOJ, with an eye toward potential enforcement actions or prosecutions.

CME has granted broad emergency authorities to its Board of Directors[1] and its Business Conduct Committee[2] (among others), which may be invoked in response to the drop in price of the May 2020 WTI contract. Exercises of emergency authority are subject only to very limited judicial review.[3] Relevant CME rules define "emergency" broadly to include, among other things, events "in which the free and orderly market in a commodity is likely to be disrupted"[4] and "circumstance[s] which may have a severe, adverse effect upon the functioning of [an e]xchange."[5] Upon a finding of an emergency, the CME, by a majority vote of its Board of Directors or by a vote of the Business Conduct Committee, can take several actions that are potentially relevant to the current situation. These include terminating trading in a contract, confining trading to a specified price range, altering conditions of delivery, and even fixing the settlement price for liquidation of the contract.[6] Exchanges have in the past reserved their most extreme emergency authorities—such as the ability to close trading—for the most extreme circumstances. For example, in response to congestion in the silver market in 1979 and 1980, the Chicago Board of Trade and the COMEX exchange raised margin requirements and tightened position limits, and COMEX ultimately suspended all trading in silver other than liquidation orders.[7] Similarly, in 1979, NYMEX suspended trading in two potatoes futures contracts and ordered all outstanding positions to be liquidated at a set price in response to failures in delivery process.[8]

CFTC could also potentially invoke emergency powers to address congestion in the May 2020 WTI contract caused by lack of storage capacity. CFTC's emergency powers authorize it to direct the CME (and other exchanges) to take certain actions. However, CFTC has very rarely invoked its emergency powers in the past and has not, as a matter of custom, invoked those powers without first giving the exchange an opportunity to address the problem. Thus, CFTC will not likely invoke its emergency powers unless and until it has concluded that CME is not adequately addressing issues related to the May 2020 WTI contract. That said, should CFTC choose to act, it has a broad range of emergency powers at its disposal. These include directing CME to alter margin requirements or position limits for the May 2020 WTI contract and extending the delivery period for the contract.[9]

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1. *See* CME Rule 230.
2. *See* CME Rule 402.
3. Exchanges are generally shielded from liability for exercises of emergency authority, provided that those exercises are undertaken in good faith and in response to a genuine market problem. In those circumstances, exchanges cannot be sued by private individuals for exercises of emergency authority. *See Sam Wong and Son, Inc.* v. *NYMEX,* 735 F.2d 653, 656–67 (2d Cir. 1984); *Lagorio* v*. Board of Trade*, 529 F.2d 1290 (7th Cir. 1976).
4. CME Rule 230(k).
5. CME Rule 402.C(1).
6. CME Rule 230(k); CME Rule 402.C(2).
7. For a description of the silver market congestion and the exchanges' response, *see* CFTC Notice of Proposed Rulemaking: Position Limits for Derivatives, 78 Fed. Reg. No. 239, at 75686 (Dec. 12, 2013).
8. *See Sam Wong and Son, Inc*. v. *NYMEX*, 735 F.2d at 656–67.
9. *See* 7 U.S.C. § 12a(9).

Whether or not CME (and / or CFTC) decides to invoke emergency authorities in the near future, the authorities are very likely in the slightly longer term to scrutinize trading in the May 2020 WTI contract.

- Traders who have violated position limits can expect to draw close scrutiny from CME, and will likely face fines and potentially trading bans.[10]
- Traders with large positions have likely already been contacted by CME and / or CFTC regarding their trading intentions and storage capacities—or will be contacted in the very near future. Such traders could be subject to civil or criminal liability for any false statements made to CME or CFTC in response.[11]
- Likewise, traders with large positions subject to an exemption on position limits (such as an exemption for hedging, risk management or spread positions) should expect that the reasons proffered in requesting the exemption, as well as their trading, will be examined. Traders found to have made misrepresentations in connection with the application for an exemption will likely be subject to penalty by CME,[12] as well as regulatory and criminal actions by CFTC and DOJ.[13]
- Finally, persons suspected of manipulating the price of the May 2020 WTI contract will likely face protracted investigation by the CFTC and the DOJ, with the potential for very large civil or criminal penalties.[14] For example, we expect that regulators will be scrutinizing whether traders with short positions intentionally congested the Cushing facility to push prices down and benefit their positions

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The dramatic drop in price of the May 2020 WTI contract is guaranteed to draw close scrutiny from CME as well as CFTC. Traders should be prepared for the possibility that CME or CFTC will invoke emergency authorities to affect trading volume, conditions of delivery, and potentially even the settlement price of the contract. Traders should further expect closer-than-usual scrutiny of their trading in the contract, with a greater risk that penalties will be levied against traders found to have violated exchange rules or the law.

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10 *See* CME Rule 562.
11 *See* 7 U.S.C. §§ 9(2) and 13(a)(4).
12 *See* CME Rule 432(L)(2).
13 *See* 7 U.S.C. § 13(a)(4).
14 *See* 7 U.S.C. § 9(1).

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