Insider Dealing in the Commodities Market

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Table of Contents

Abstract

Since 2009 there has been a flurry of activity where new legislation has been introduced in order to create stability across the global markets as well as create greater transparency. Part of this initiative has meant creating better harmony of regulation. In the next couple of years the Market Abuse Directive II and its corresponding Regulation; the Market Abuse Regulation will come into force across Europe, introducing criminal sanctions for all insider dealing across the European Union. Increasingly, the global markets are becoming further inter-linked, thus creating substantial risk to the global economy. The commodities markets are now being reformed and the light touch regulation once enjoyed by traders, in the commodities markets is now drawing its final breath. As the one era comes to a close and a new one dawn's there is still a great deal of discussion taking place around the necessity for this regulation. Insider dealing is rife in the securities markets but is it really possible to effectively commit this crime in the commodities markets? This dissertation will explore the efficiency of the incoming regime and whether this is a credible deterrent or merely a way in which to conform the regulation across the markets and asset classes.

Introduction

Financial regulation has changed rapidly over the past few years, as it has been forced to keep pace with the dynamic and changing environment of the global economy. This is especially true for the commodities market which is being bought into line with securities regulation. In the near future Insider Dealing will become illegal under European regulation as criminal sanctions will be introduced under the Market Abuse Directive II (MADII)[1] and the Market Abuse Regulation (MAR)[2], this will be effective across the market and across asset classes, including commodities, the first time that commodities have been recorded independently to the securities rules. Insider dealing[3] has carried criminal sanctions in the United Kingdom (UK) since 1993 and the United States (US) for many years.

Since the collapse of the financial markets in 2008 there have been calls for increased transparency. A large proportion of the blame, for the failure of the markets was placed on complex derivatives trading. These trades linked not only the banks intrinsically, but also the global financial markets, which in turn created systemic risk Inevitably the consequences of this systemic risk created issues throughout the banking system, including retail. At a meeting of the G20 leaders in 2009, it was agreed that the commitment to ensuring market stability would be renewed thus ensuring that the global markets exhibited greater transparency, this created the need for additional regulation. Furthermore the message from the G20 leaders was clear in that there could be no room for another failure of the financial system and therefore.

In the US this has been in the form of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"); whilst in Europe there have been several new regulatory reforms these include, Markets in Financial Instruments Directive II ("MiFID II"); European Markets Infrastructure Regulation ("EMIR"); Regulations on Wholesale Energy Market Integrity and Transparency ("REMIT"); Market

[1] European Commission Proposal for a Directive of the European Parliament and of the Council on insider dealing and market manipulation (market abuse), (2011), 2011/0297 (COD)
[2] European Commission Proposal for a Regulation of the European Parliament and of the Council on insider dealing and market manipulation (market abuse), (2011), 2011/0295 (COD)
[3] This practice is termed as "insider dealing" in the UK and Europe and as "insider trading" in the US

Abuse Regulation ("MAR") and the Market Abuse Directive II ("MAD II") each of these regulatory initiatives attempt to bring its own level of transparency to the markets. Essentially it would appear that the regulation is designed to complement each other, but inevitably there will be an overlap. What has become apparent is that whenever a major failure occurs, the global leaders and regulators appear to respond with a new regulation. This was evident during the last decade, with the failure of Enron and the accountancy firm Arthur Andersen, the response by the US government was to create the Sarbanes-Oxley Act to improve internal accountancy and audit standards.

There have been numerous scandals in the recent past that both directly and indirectly affect the consumer these include the price fixing or collusion allegations levelled against British Petroleum (BP); Statoil and Shell, with European regulators conducting dawn raids on their offices. In addition the "LIBOR"[4] scandal, created a great deal of concern about the rate fixing between high street banks. Whilst none of these cases amount to insider trading in its strict and exact sense they are worth mentioning as other forms of market abuse. Therefore, it is for the reasons mentioned above, that there appears to be a necessity to close loopholes and provide a more robust regulatory framework.

This dissertation will explore the aspects of insider dealing within the commodities market, by discussing how information is used in relation to the commodities market; and if this can be construed as "inside information". A key aspect of this discussion will be to consider the rise of commodities regulation and the role of exchanges in the process of regulation; in addition to this there will be an examination of the regulatory response to the potential for insider trading. This will be undertaken by reviewing current regulation as well as incoming regulation, where this is deemed appropriate. An analysis of other types of market abuse will be presented, along with an exploration of the existing "insider trading" laws and the most recent convictions. The conclusion will highlight the main aspects of the dissertation and consider the relevance of enhanced regulation.

[4] London Interbank Offered Rate

It is not the intention to debate insider dealing, per se but rather the relevance of this activity in light of the new Directive as well as the comparison to other forms of market abuse. Proving insider trading in the commodities markets is going to be extremely difficult, in fact it could be said that it is virtually impossible for this activity to occur, however market manipulation on the other hand is rife and the authorities are beginning to take a far more active role in pursuing this activity as will be seen in chapter five. Proving insider dealing will not only be extremely time consuming, it will require specialist investigators and will be an extremely costly exercise. It can be argued that the regulators are merely seeking a greater deterrent and a means to having greater conformity across the markets.

Finally, it is important to highlight that certain articles use the term Insider Trading rather than Insider Dealing. The latter is the term that is used in the UK and across Europe, therefore this will be the phrase that will be used in this dissertation when not directly linked to an article of which the former is in the title or referred to in the subject matter.

Chapter 1

Insider dealing explored

1.1) Overview

The purpose of this chapter is to explore the issues relating to insider dealing as well as some recent cases in the equities market. Furthermore it will provide the groundwork for the discussion on the concept of inside information in the commodities market in chapter 3 and then further discussion of insider dealing as behaviour in chapter 4. This is intended to be a short chapter as the detail will be provided later in the dissertation. Furthermore, the discussion in this chapter centres around trading in the securities markets as there are to date, no recorded instances of such activity in the commodity and related derivatives markets. That is not to say that it doesn't occur, but there have been no convictions.

In the article entitled "Insider Trading", King and Roell[5], state that this action is "more than a theft of information". With this statement in mind it is vital to discover what insider dealing encompasses, and why the authors refer to this as more than mere theft of information. Many of the academic articles researched whilst preparing for the drafting of this dissertation refer to a distinct lack of clear definitions for insider dealing, as well as a clear definition of the term "insiders". This issue seems to have been resolved in more recent years with both legislation in the EU and US providing clearer clarity for these terms. For this reason it is important to examine the law in both the UK and the US.

1.2) The law outlined

1.2.1) UK

[5] Mervyn King, Ailsa Roell, John Kay and Charles Wyplosz, Insider Trading, Economic Policy 3:6, (1988), 1

In the UK prior to the Market Abuse Directive coming into effect in 2003, the UK relied on the Code of Market Conduct under FSMA 2000 which provided for three offences of Market Abuse: misuse of information (insider dealing), false and misleading impression (misleading statements and practices) and distortion (rigging a market).[6]

Insider Dealing is an offence under the Criminal Justice Act 1993[7], ("CJA") s.52 sets out the offence as: an individual is guilty of insider dealing if he or she trades, based on information held as, an insider when either acquiring or disposing of securities on a regulated market when relying on a "professional intermediary" or the individual acts as that intermediary. Furthermore the individual is guilty of this offense if he or she encourages another person to deal or trade, regardless of whether or not the other person is aware of the fact that this will constitute insider dealing. The individual discloses the information outside the "functions of his employment, office or profession, to another person. The defences for insider dealing are provided in s.53[8] the: An individual is not considered guilty of insider dealing (in securities)nor is he or she guilty of insider dealing by virtue of encouraging others to trade if the individual concerned can prove that: at the time in question he / she did not expect the trade to result in a profit directly related to the information nor that the information in question was price-sensitive; the individual believed the distribution group was sufficiently broad so no one participating in the deal would be disadvantaged by this action and finally that the individual would still have gone ahead with the trade (either sale or purchase) even if not privy to the information held. Finally an individual will not be guilty of insider dealing regarding disclosure of information if he or she can prove that: he did not expect anyone else to trade due to the disclosure of this information[9]or whilst the individual may have had an expectation at that time, the individual concerned did not expect the

[6] A Alcock, 'Five Years of Market Abuse', Company Lawyer, 1
[7] Criminal Justice Act 1993 c. 36,Part V, s. 52
[8] Criminal Justice Act 1993
[9] … based on information held as, an insider when either acquiring or disposing of securities on a regulated market when relying on a "professional intermediary" or the individual acts as that intermediary.

result to be a profit directly linked to the fact that the information was price-sensitive in relation to the securities.

1.2.2) US

Rule 10b5 is well known as the rule which governs insider trading in the US. In an amendment that took place in October 2000 the SEC[10] attempted to clarify the rules concerning insider trading under rules 10b5-1 and 10b5-2[11], this amendment is relevant to the new rule created by the CFTC on insider trading and which will be referred to in Chapter 3. "Rule 10b5-1 provides that a person trades on the basis of material non-public information if a trader is "aware" of the material non-public information when making the purchase or sale."[12] In addition the rule sets outs some defences, by permitting individuals to trade in situations where it is obvious that the information does not influence the individual concerned, regarding their decision to execute the trade. Rule 10b5-2 clarifies how the misappropriation theory applies to certain non-business relationships. This rule provides that a person receiving confidential information under circumstances specified in the rule would owe a duty of trust or confidence and thus could be liable under the misappropriation theory.[13]

1.3) What is an insider?

This heading has deliberately been posed as a question. As noted in the chapter overview there are a number of scholars who have expressed that the definition of an "insider" has not been adequately defined by the law, this in turn creates "a significant amount of legal uncertainty for end users and intermediaries"14 (Brown-Hruska and Zwirb, p.252). Under the CJA15 an insider is defined in s. 57 ("Insiders") as follows For the purposes of the Act an "Insider" is defined in s.53 as a director,

10 http://www.sec.gov/rules/final/33-7881.html
[11] This amendment addresses the following issues: the selective disclosure of material non-public information by issuers and to clarify two issues under the law of insider trading (as noted in the Executive Summary, n.26)
[12] http://www.sec.gov/rules/final/33-7881.html
[13] http://www.sec.gov/rules/final/33-7881.html
[14] Sharon Brown-Hruska and Robert S Zwirb, "Legal clarity and regulatory discretion – exploring the law and economics of insider trading in the derivatives markets", (2007), 252
[15] Criminal Justice Act (n. 7), s. 57

employee or shareholder of an issuer of securities; or someone who has access to the information during the course of his or her employment, office or profession or the individual concerned has sourced the information either directly or indirectly through a person noted above." From this it would appear that the UK law has defined an insider, however this is subject to interpretation and it is clear that cases of insider dealing are extremely difficult to prove and costly to prosecute. In ***Chiarella v. United States***, 445 U.S. 222 (1980)[16] an employee of a printing company who was involved in printing documents relating to corporate mergers and takeovers managed to ascertain which companies would be involved and purchases shares in those companies. The US Supreme court ruled that *Chiarella* did not act in contravention of the SEC Rule 10-b and was not considered to be an insider.

1.4) An ethical debate?

Whilst not directly linked to the ethics of insider dealing, one academic article[17] suggests that some economists and legal scholars assert that the prevention of insider dealing by those who have knowledge of key events within an organisation; creates a certain inefficiency within the markets. These scholars contend that such activity by these insiders would ensure that the key information would affect the stock price quickly, thus removing the inefficiency of the markets. While[18] this view is supported by a number of proponents of insider dealing, the opponents state that this activity will affect issues such as liquidity, promotes abusive behaviour and additionally it is considered detrimental and inequitable to shareholders as well as other investors. (Meulbroek, 1992).

[16] Kim Lane Scheppele, 'It's just not right: The ethics of insider trading', (1993) Law and Contemporary Problems, 125
[17] *Ibid*
[18] Lisa K Meulbroek, "An empirical analysis of Illegal insider trading", (1992), The Journal of Finance 47:5, 1661

As noted by many scholars [19]"In the end, making insider trading illegal means that someone other than insiders will get the first crack at trading on it." (Brown-Hruska and Zwirb, 2007). Therefore, as illustrated above there seem to be a number of scholars who believe that insider dealing does in fact have a positive effect on the market. In the final section of this chapter some of the most recent insider dealing prosecutions will be discussed and it will examine the question as to whether these individuals are casual opportunists rather than hardened fraudsters. Having considered the issues as to why insider dealing could possibly have a positive effect on the market, the discussion now turns to consider the issues of the harm that this might do to the market as well as the victims of this crime. Kim Lane Scheppele[20] in her article states that: "fiduciary duty creates an obligation not to use any information acquired within the relationship only because such relationships provide privileged access to information." The author continues her argument by stating that the issue centres on "equal access". In other words if only one party has access to information that is privileged, then the access is not fair as it is not shared by all parties. In this type of situation the victim of insider trading would be the individual or organisation (the owner) who has delivered the information to the person who holds the fiduciary duty; the essence of this relationship is one of trust. So regardless of whether or not this is unfair to other parties who may not possess this information, it is unfair to the *owner* of the information. The law is fairly explicit in its intentions but the defences provide room for manoeuvring.

[19] Professor Richard Booth, Wall Street Journal article in 1991, as quoted by Brown-Hruska and Zwirb (n. 14)
[20] Kim Lane Scheppele (n.16) 126

1.5) Effect on price

In the previous section that view that insider dealing could have a positive effect on the prices of stock, was put forward. In this short section this issue will be raised as discussed by Albert S. Kyle[21]

> "in the particular model investigated, one risky asset is exchanged for a riskless asset among three kinds of traders: a single insider who has unique access to a private observation of the ex post liquidation value of the risk asset; uninformed noise traders who trade randomly; and market makers who set prices efficiently, conditional on information they have about the quantities traded by others." (Kyle, 1985)

The results presented as follows:

> "The informed trader trades in such a way that his private information is incorporated into prices gradually …. Furthermore all of the insider's private information is incorporated into prices by the end of trading in continuous auction equilibrium" (Kyle, 1985)

1.6) Prosecutions of Insider Dealing in both the UK and the US

It is apparent that there has been a dearth of convictions relating to insider dealing within the commodities sector. Until more recently the law has been rather opaque in this area; however this will become clearer as new legislation becomes effective. The subject matter itself is highly complex and obtaining a conviction will prove costly and time consuming for the authorities. It is also important to bear in mind that this is merely one aspect of market abuse. Other aspects of market abuse will be discussed in more detail in chapters 4 and 5. According to the CJA at s.61 conviction of insider dealing carriers the following tariffs: in the lower courts the guilty party can receive a fine

[21] Albert S Kyle, Continuous auctions and insider trading, (1985) Econometrica 54:6, 1

limited to the statutory maximum and / or six months in prison; conviction by a Crown Court can result in a fine (it does not state that this fine is limited) and / or 7 years imprisonment. The FSA has taken the option to prosecute as other methods of sanction did not appear to provide a strong enough deterrent. In the UK there have been a number of convictions for insider dealing, recently. The most significant being the conviction of Christopher McQuoid[22] and his father-in-law James Melbourne. This was the first prosecution secured by the Financial Services Authority ("FSA"),[23]hence the significance of this case. McQuoid was employed as in-house counsel for TTP Communications, when he was informed in confidence that Motorola were planning to buy out the company. McQuoid passed this information on to Melbourne who then purchased shares in TTP Communications at 13 pence per share, two days before the information was made public. Melbourne had previously not traded in shares of any company. The price of the stock increased to 45 pence per share as agreed in the purchase agreements. Melbourne made a profit of £48,919.20 which was shared with McQuoid. McQuoid received an eight month prison term, whilst Melbourne received the same term suspended for 12 months. Since then the FSA / FCA have secured 23 convictions[24] in insider dealing. As noted in this statement from the FCA another 7 cases are awaiting trial.

The US regulators have also been successful in securing convictions in insider trading, and some of these cases have involved high profile individuals. Whilst none of these cases provide precedents they are an important indicator of things to come as the regulator in the UK seems determined to eliminate this activity. Furthermore, as the new laws come into effect and insider dealing and market manipulation are criminalised across the EU, the FCA will continue on this path of enforcement and as will be demonstrated in chapter 5, there will be an increase in cross-border co-operation between the various regulators. Whilst reviewing the SEC's website[25], as part of the research for this dissertation

[22] http://www.fsa.gov.uk/library/communication/pr/2009/042.shtml
[23] The Financial Services Authority has ceased to exist and one of the successor regulators is the Financial Conduct Authority ("FCA"), it is the FCA which will be responsible for regulating conduct
[24] http://www.fca.org.uk/news/two-arrested-in-fca-insider-dealing-investigation
[25] http://www.sec.gov/spotlight/insidertrading/cases.shtml

it is quite clear that the regulator carries out its duties in fighting insider trading, very seriously and with great determination. Not only is it in the process of pursuing cases in the US but does so, on an international scale as well. Raj Rajaratnam[26] was convicted for his part in, insider trading involving hedge fund manager Galleon Group which he founded. Following his arrest the hedge fund manager was forced to close. This has been a complex and intricate web of involvement from many individuals and companies. A quick glance through the list of enforcement cases on the SEC website will provide some detail as to the widespread involvement.

[26] *ibid*

Chapter 2

Background to the physical commodities market

2.1) Introduction

The purpose of this chapter is to set the scene to explain the different factors that play a role in trading commodities. Derivatives have evolved as a means of trading commodities more conveniently as this will negate the need for storage facilities. Later in this chapter the derivative instruments will be discussed, a derivative is defined by Chisholm as: "an asset whose value is derived from the value of some other asset, known as the underlying."[27] The underlying will relate to the specific commodity involved, this could be an energy product, agricultural products or metals. Centuries[28] ago agricultural products were traded locally and it is from these humble origins the markets have developed into diverse global markets that span the realms of energy, agriculture and metals. Supply and demand have created the need for a viable trading system.

2.2) Market Participants[29]

Introducing each of the market participants is integral to this dissertation as the possibility for each of these participants to be involved in insider trading will be discussed in more detail in Chapter 3.

[27] Andrew M Chisholm, *Derivatives Demystified*, Wiley Finance, 1.
[28] Piero Cinquegrana, "The need for transparency in commodity and commodity derivatives markets", (December 2008), ECMI Research Report, 3
[29] Chisholm, (n. 27), 2

Dealers[30] are involved in the sale of derivatives contracts which can be bought and sold on exchange, known as exchange traded derivatives contracts

Hedgers[31] are generally large organisations which can include corporations, investment institutions, hedge funds, banks and governments, who wish to reduce their risk. However there are smaller companies that are now engaging in this practice in order to protect cash flow. Where there is a high dependence on a certain type of commodity, for example fuel, the company may want to hedge against volatility in fuel prices (particularly against an increase). Another example relates to currency movement, where a company is expecting payment of invoice at a future date in a foreign currency. (Generally commodities are quoted and sold in US Dollars but payment may be received in Euro's.) The company may enter into a forward with a bank whereby the incoming currency is exchanged for an agreed amount in the appropriate currency.

Speculators[32] are either individuals or companies who take positions in the market, where they believe they can make money quickly. Essentially this is betting that the price will either increase or decrease. Derivatives provide an alternative method of trading in this environment, as the purchase of physical commodities would require extensive warehousing facilities. By trading derivatives the settlement will be cash rather than physical. Depending on the type of derivative this can either be at the end of a specified period or at a time chosen by the customer to close out. Speculation is a cause of concern for the regulators. Generally[33] there is a great deal of mistrust of the speculator as stated by one academic "the speculator is frequently viewed as a sinister character". The author quotes a statement by Senator George Mc Govern[34]:

[30] *Ibid*
[31] Chisholm, (n. 27), 2; John C Hull, *Options, Futures and other Derivatives*, 3rd Edition, Prentice Hall, 11
[32] Chishom, (n. 27), 2; Hull (n.31), 11
[33] Joseph J. Bianco, The mechanics of futures trading: Speculation and Manipulation, (1977) Hofstra Law Review 27, 31
[34] *Ibid*

> "The people's interest in commodity trading transcends the orderly functioning of those markets and the prevention of outright fraud. For every time a speculator turns an unreasonable profit by trading futures, the housewife and the consumer pay the price. And since it is the speculator, not the producer, who receives the windfall profit, the higher wholesale and retail prices do not act as a stimulant to production."

Arbitrageurs[35] usually construct a deal that produces risk free profits by taking advantage of a mispricing in the market. Simply, put this is when a trader can buy a product reasonably in one jurisdiction and then sell it at an elevated price in another jurisdiction; or as stated by Hull[36] "locking in at a riskless profit by entering simultaneously into transactions in two or more markets." These situations will not exist for long as pricing gap will reduce once the market becomes flooded.

2.3) Actors[37]

This[38] is an assorted group, which varies according to the type of commodity in question. Generally, these will include "producers[39] such as farmers, oil producers, refiners, electric utilities, mining companies and others".

2.4) Instruments of choice

The main instruments used when trading commodities are futures, forwards, options and OTC swaps. The instruments are important as they are a means by which an insider could commit insider trading, but they carry no intrinsic value of their own. The underlying commodity, however, will carry the value; indeed the underlying commodity that will be subject to inside information. The reason that

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[35] Chisholm, (n. 27), 3
[36] Hull, (n. 31), 12
[37] Cinquegrana (n. 28), p.3
[38] *Ibid*
[39] *Ibid*

derivatives are traded is due to the fact that buying and selling physical commodities means having the associated costs of warehousing (storage) and transportation.

Forwards[40] are contracts that are agreed between two parties to buy and sell a commodity, on a specified future date and at a price, fixed and agreed at the outset of the agreement. The first recorded corn contract was traded in 1851 by a group of 82 Chicago merchants. This group eventually became known Chicago Board of Traders ("CBOT").

Futures[41] are traded on exchange and are standardised contracts. Similarly to forwards, a future is a contract to buy or sell goods at a fixed price on a future date or these may even be a range of dates. Both forwards and futures date back to ancient times. In medieval times, sellers of goods at European fairs signed contracts promising delivery on future dates. Futures also date back to rice trading in Japan; during the 17th century feudal lords collected taxes in the form of rice, and then sold the rice in exchange for cash. Bidders were issued with vouchers, freely transferable. Contracts became standardised on rice, rather like today's futures.

Options[42] contracts provide the buyer with the right (to buy) but the buyer is not obligated to do so. There is a difference in Options traded in Europe to those traded in the US. The former can only be exercised at expiry whereas the latter can be exercised at any time, up until expiry. Options can be bought (call) or sold (put) at an agreed amount of a commodity (this is called the underlying, and can relate to any asset), at a specified price (exercise or strike price) on a future date (expiration date). These can either be concluded on exchange or over the counter ("OTC"). According to Chisholm[43] the first options contracts was effectively concluded by the Greek Philosopher, Thale. Through astronomy

[40] Chisholm, (n. 27), 11
[41] Chisholm, (n. 27), 39
[42] Chisholm, (n.27), 69
[43] *Ibid*

Thale came to the conclusion that a bumper crop of olives were to be yielded during the harvest. He therefore decided to place deposits on a large number of olive presses which were leased during the harvest. Effectively this became the first Options contract.

Swaps[44] are agreements made between two parties to exchange payments on regular future dates, where the payment legs are calculated on a different basis. These contracts are agreed on an over the counter basis ("OTC") and are therefore more risky, as either side may default on its obligations. These are usually negotiated under ISDA[45] agreements, which is a contract that is negotiated for the mutual benefit of both parties, although the party extending credit, will have a stronger remedy at its disposal, in the even to a default.

2.5) Foreign Exchange

Foreign exchange is a fundamental part of the commodity derivatives trading environment. As the foreign exchange markets can be extremely volatile with daily (and depending on the circumstances) and even intra-day price movement, consumers and traders will generally hedge their foreign exchange risk in order to avoid losses, by utilising the instruments noted above. Gains made along the way provide a way to make money. The commodity market is dominated by the US Dollar, so there will always be a necessity for foreign exchange and the management of such risk.

2.6) Markets and Indices

Each area of the commodities market will have its will have its own specialised markets and indices from which products are priced. For example in the oil markets the Brent market is one of the largest and most liquid markets.

[44] Chisholm, (n. 27), 2;49
[45] International Swaps and Derivatives Organisation

2.7) Commodity Exchanges

There are a number of commodity exchanges around the world; however for the purpose of this topic the most noted exchanges are included in the table below. The role of the exchanges in regulation will be discussed in more detail in chapter 3.

Exchange	**City**	**Product**
London Metals Exchange (“LME”)[46]	London	Industrial Metals and Plastics
London Commodity Exchange (“LCE”)	London	Agricultural
Climex (“CLIMEX”)	Amsterdam	Emissions
NYSE Liffe (“LIFFE”)	Europe	Agriculture
European Climate Exchange (“ECX”)	Europe	Emissions
European Energy Exchange (“EEX”)	Leipzig	Power, Natural Gas, Emissions and Coal
Deutsche Borse (“DRAG” / “EUREX”)	Frankfurt	Agricultural, Metals, ETC’s, Commodity index
Chicago Board of Exchange (“CBOT”)	Chicago	grains, ethanol, treasuries, equity index, metals
Chicago Mercantile Exchange (“CME”)[47]	Chicago	Meats Currencies Eurodollars equity index
Chicago Climate Exchange (“CCX”)	Chicago	Emissions
Intercontinental Exchange (“ICE”)[48]	Atlanta	
New York Mercantile Exchange(“NYMEX”)	New York	Energy, Precious Metals and Industrial Metals

[46] www.lme.com
[47] CBOT, CME, CCX and NYMEX are all part of the CME Group.
[48] The International Petroleum Exchange (“IPE”), is now known as ICE Futures, a division of ICE

2.8) Summary

The reason for trading derivatives is due to the level of volatility in the commodities market. Therefore many organisations that rely on physical commodities (for example, fuel for transportation), in their day to day business requirements; will require some level of certainty for the management of the budget. This is sometimes referred to as Price Risk Management. For this reason they may choose to hedge and use a derivative instrument in order to mitigate the risk of a price going up, it is fair to say that should the price go down they run the risk of not making as much money. This example is used day in and day out and not just in the oil markets but also for agricultural products and metals.

In summary this chapter forms part of the foundation for the rest of this dissertation as each of these components parts are integral to understanding insider dealing within the commodities and the associated derivative market.

Chapter 3

Commodities Markets and the use of “inside” information

3.1) Overview

The purpose of this chapter is to reflect on the meaning of “inside information” as it relates to the commodities market. In order to analyse this definition in detail, it has been broken into constituent parts.

3.2) Defining “Inside Information”

The definition of inside information is noted in various regulations and directives. However, these all reduce to one common theme: 1) information that is of a precise nature which has not been made public; (2) said information will also relate to one or more issuers of financial instruments; (3) to one or more financial instruments, if this were to be made public, it would very likely have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments.[49] Phrases such as non-public, material information when trading are also often used in this context.[50] MAR[51], Article 6 (1) (b) defines insider trading in commodities markets:

> “as information of a precise nature, which has not been made public, relating, directly or indirectly, to one or more such derivatives or to the related spot commodity contract, and which, if it were made public, would be likely to have a significant effect on the prices of such derivatives or related spot commodity contracts; notably information which is required to be disclosed in accordance with legal or regulatory provisions at the Union or

[49] Directive 2003/6/EC (on insider dealing and market manipulation (market abuse))
[50] Securities and Exchange Commission Rule 10B
[51] European Commission Proposal for a Regulation of the European Parliament and of the Council on insider dealing and market manipulation (market abuse), (2011), 2011/0295 (COD), 29

> national level, market rules, contracts or customs on relevant commodity derivatives or spot markets."

The Directive:[52] will seek to criminalise insider trading across markets and asset classes, Article 3 states that:

> "Member states shall take the necessary measures to ensure that the following conduct constitutes a criminal offence, when committed intentionally:
>
> (a) when in possession of inside information, using that information to acquire or dispose of financial instruments to which that information relates for one's own account or for the account of a third party. This also includes using inside information to cancel or amend an order concerning a financial instrument to which that information relates where that order was placed before entering into possession of that inside information; or
>
> (b) disclosing inside information to any other person, unless such disclosure is made in the lawful course of the exercise of duties resulting from employment or profession.

3.3) "Precise Information" relating to commodities

Whilst conducting research for this dissertation a significant number of academic articles relating to insider dealing were available, very few dealt with the issue of this activity, solely, within the commodities market. The obvious conclusion to be drawn from this lack of information is: either there have been no such instances within the commodities market or alternatively this may be happening but to date there have been no prosecutions. The word "precise" is defined as "exact and

[52] European Commission Proposal for a Directive of the European Parliament ……

accurate, or detailed and specific." The term "precise information" is clear when used in the framework of equities or securities, as it relates to information that is exact. An example of this would be in the case of an acquisition, tangible information would be exchanged; details of the company being acquired, the price, as well as knowledge of how this would affect the share price following the relevant announcements. This is information that would only be shared amongst "insiders". In the commodities markets however, it would be difficult to be that specific about the information. Commodities markets are generally driven by major events which could be economic, social or political. Two examples of this (1) would be the fluctuation of wheat prices depending on weather conditions; and (2) similarly the price of oil will fluctuate in relation to political events. Obtaining precise information relating to commodities would be very difficult as no one entity[53] will own the entire[54] "value chain of the commodity". By using derivatives buyers and sellers can lock in at a price before the market shifts one way or the other; in addition these instruments mean that they do not have to take delivery of the physical commodity. In theory a potential insider could buy futures in a commodity, based on the information that has been acquired in the course of their business. Brown-Hruska and Zwirb provide a helpful summary [55] when putting into context why there has (possibly) been no embargo on insider dealing in the commodity derivatives sector:

> "Equities represent claims on the assets of the firm, providing an ownership stake that subordinates the managers and employees of the firm. As debt obligations, bonds issued by the firm along with equities, provide a company with a vehicle to raise capital. This purpose of capital formation is considered distinct from the purpose of commodity derivatives and other financial assets, which are primarily used for price discovery and

[53] For the purpose of this dissertation "entity" relates to an individual or organisation
[54] On Insider Trading in the Commodities Market, Rakesh Neelaakandan
[55] Sharon Brown-Hruska and Robert S Zwirb, (n. 14), 252

risk management. In the equities side, regulation has traditionally been tilted, if you will, towards the providers of capital, in short, the investor." (Brown-Hruska and Zwirb, 2007)

Insider dealing within the commodities markets needs to be considered in two strands, the first being the type of derivative instrument used and the second being the underlying commodity. There are a variety of instruments that can be used and these are all generally regulated. The scope of regulation is broad as the different types of businesses engage in commodities trading. For example commodities traded in a bank[56] will be regulated on a different basis and under a stricter regime than those traded by a company that is involved in trading as ancillary business[57].

In a recent article published by the news agency Reuters a concern was expressed that this change to the regulation could "force traders to reveal their trading strategies and undermine their businesses".[58] Another noted academic stated that better information did not necessarily equate to inside information.[59] Again this clearly intimates that both academics and professionals believe that insider dealing in commodities is not going to be a cut and dried issue.

3.4) The concept of front-running as insider dealing

Front running[60] is a form of insider dealing and one which has been blamed for the collapse of the markets on "Black Monday".[61] Markham states that "the practice of front-running involves a

[56] MiFID Directive 2004/39/EC afforded certain firms carve outs or exemptions which meant that in the UK a firm authorised as an Oil Market Participant has a "lighter touch" regulatory regime than a bank which is subject to full regulation, this includes, *inter alia*, capital requirements and transaction reporting
[57] Directive 2004/39/EC provides the following exemptions: Dealing on own account, Article 2 (1)(d); Ancillary business, Article 2(1)(i) and Commodity Dealer, Article 2(1)(k)

[58] uk.reuters.com/article/2013/06/14/commodity-regulations-idUSL5N0EO2H32013614
[59] *Ibid*
[60] Jerry W. Markham, ' "Front-Running" – Insider Trading under the Commodity Exchange Act', (1988) Catholic University Law Review 38:69, 69
[61] Black Monday is the name for 19 October 1987 when huge losses were sustained across the markets

transaction in a commodities futures contract or a stock option contract by a trader with "material" non-public information concerning a block transaction in the commodity or security underlying the futures or options contract".[62] This is significant as it applies directly to the commodities market. According to the author of this informative article this practice was observed on the Chicago Board Operations Exchange ("CBOE"),[63]first. As the CBOE continued to expand by diversifying into stock options, as a result liquidity and institutional participation increased significantly; as such market abuse started to increase as well. Front-running was identified as one of these abuses. This was identified by the SEC in 1977 as: (Markham, 1988)

> "The practice of trading a security while in possession of unreported information concerning a block transaction in the same or a related security. [Because of] Due to the derivative nature of the pricing of options …. [front-running] is usually associated with the trading of options based upon knowledge of an unreported block transaction in the underlying security which presents an opportunity to take an options position at a more favourable premium than would be available after the publication of the block transaction. The knowledge may relate to a transaction which has not been finally agreed to but which in the relevant circumstances is nonetheless almost certain to go through, or it may relate to a transaction that has been consummated, by not yet reported."[64]

The CBOE proposed a rule against, front-running, however for several reasons the SEC did not pursue this and the CBOE then withdrew its proposal. Markham states though that the SEC has largely allowed the exchanges to manage this activity. The article is detailed, and it is possible to expand fully, the topic of front-running is worthy of a dissertation in itself. The reason for

[62] Markham (n. 60), 70-71
[63] According to Markham the CBOE is "the world's first and largest organised stock options exchange." This was "created by the Chicago Board of Trade ("CBOT") to apply commodity futures trading principles to securities transactions."
[64] Securities Exchange Act Release No. 14,156, 13 SEC DKT. No. 661 (Nov. 9, 1977) as quoted by Markham (n.60), p. 74-75

mentioning this issue is that front-running is possible within the commodities market and the information required; does not have to be that precise. However, it is possible that this type of practice may be limited if not eradicated with time-stamping being brought into effect under Dodd-Frank.

Markham[65] continues in his article by stating that this can be considered as "fraud on the market" or certainly this is one type of theory presented. He states that this has theory has been

> "upheld in *Basic Inc. v. Levinson* by 4 members of the Supreme Court. This fraud theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business. Consequently, misleading statements will be publicly disseminated, affect all market prices and will defraud purchasers of stock, even if they do not directly rely on the misstatements. The required casual connection between damage and injury is established by the fact that the affected investors were trading on an organised exchange that would reflect a true value if the misleading nature of the information was known."

3.5) Insider dealing

Unlike equities commodities are tangible; in addition no one owns a commodity in its entirety. There will be numerous companies involved, from those that are responsible for the excavation of the commodity, through to the refiners or factories. A simple example is buying shares in company X, when the purchaser has been made aware that a corporate takeover or merger is imminent. In contrast an individual may sell shares in company Y, prior to a major announcement that might significantly lower the price of stock or shares. These are two simple examples of insider trading. When looking at the FCA rules they do not differentiate between insider trading in commodities and

[65] Markham, (n. 60), 70-72

equities, but it is safe to assume that these rules will probably be revised following the adoption of MAD II. The significant number of convictions, however, have all been due securities trading. However, there has been some interest in the warehousing of commodities, and there have recently been cases regarding this matter.

> In[66] the decision in "*SEC v. Texas Gulf Sulphur Co*., the US Court of Appeals for the Second Circuit adopted the *Cady Roberts* prohibition, stating that "anyone" in possession of material inside information: 'must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed."

A well-used adage states that "knowledge is power" and it this is certainly true when it comes to knowledge of inside information. King and Roell[67] state that "Information is often much more valuable if its possession is exclusive. Knowledge of a piece of information for even a period as short as a few minutes can have a very high private but almost no social value. "The authors continue by providing the following example: "On Thursday, 20 August 1987 bank lending figures that were much worse than anticipated were published at 11.30am. The stock market (FT-SE 100 index) fell 70 points. Any individual who had access to those figures at 11:20 (an insider) could have made some very profitable transactions. This is precisely why the release of such figures, and others such as company results, is organised so as to give all investors and market makers equal access."

3.6) The argument against criminalising insider dealing in the commodities market

[66] *Ibid*

[67] King and Roell, (n. 5), 165-166

The argument from those that market and trade in commodities and related commodity derivative products; is that the new regulation will impede competition, and will damage the ability of free flowing trading. It is evident that the incoming regulation is draconian and perhaps there is some need for improved regulation but to a lesser extent. It is fair to say that whilst commodity traders have enjoyed a relative free reign, many traders are not risk adverse and will most certainly flout the rules for their own gain. However, even with such regulation it is evident that there are those who will continue this practice as they believe the possible gains outweigh the risks. The issue is intrinsically linked to the underlying commodity, and knowledge that is exclusive to that market, however the real problem has been with the complexity of the instruments used for trading these products. The whole basis of the commodities market is driven by knowledge – knowledge that is passed between traders on a frequent basis. Every commodities firm is in business to make money. It seems likely that the derivative most open to this type of abuse will be futures, and possibly options. However, it is impossible to invest in futures in the same way as one would invest in securities.[68] Bianco states that in theory it is possible for a trader to hold a long or short futures position for up to eighteen months, however this is unlikely and the reality is that such positions will only be held for one or two months at the longest.[69] Swaps require a great deal of negotiation and whilst these may be used in other types of market manipulation it is improbably that these will be used for insider dealing. Insider dealing requires vehicles that provide speed and flexibility, as noted above these will generally be futures or options.

[68] Bianco (n. 33), p. 31
[69] *Ibid*

Chapter 4

The emergence of the regulatory regime of the commodities market, including exchanges

4.1) Overview

This chapter will review the evolution of regulation of the commodities arena in the US, UK and Europe. The purpose is to review the various bodies and the management these have of insider trading. There are a number of factors that come into play when looking at regulation of the commodities market; these include clearing houses; exchanges; as well as the overarching regulation. The second half of this chapter will review the way that global regulators have responded to the crisis, in their quest for greater transparency. In the US commodities have been regulated by various bodies for a number of years. Each of these bodies will be discussed in section 4.3.

4.2) United States of America

The US is more advanced in its regulation of commodities in that it has different regulators to manage to the markets; it also has far more exchanges.

4.2.1) Securities and Exchange Commission (the "SEC")

The SEC states that it is its mission "to protect investors maintain fair, orderly, and efficient markets, and facilitate capital formation".70 The organisation is the chief regulator in the US and operates at Federal level, having control over varied markets and practices.

4.2.2) The Commodities Futures and Trading Commission (the "CFTC")

[70] http://www.sec.gov/about/whatwedo.shtml

The CFTC is responsible for regulation of the commodities markets as well as enforcement of rules in these markets. Under the Dodd-Frank[71] regulation the CFTC are set to introduce a version of the SEC's Rule 10-b. The rule is referred to 180.1 and "prohibits manipulative and deceptive devices and contrivances in connection with any swap, or a contract of sale of any commodity in interstate commerce, or for the future delivery on or subject to the rules of any registered entity."

4.2.3) The Federal Energy Regulatory Commission (the "FERC")[72]

This is an independent national body that is responsible for the regulation of electricity, natural gas, and oil, when transferred between states.

4.2.4) Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act")

Insider Trading is also dealt with under the Dodd-Frank Act at sec.746[73] of the act it states that, in the first instance it amends Section 4c(a) of the Commodity Exchange Act (7 U.S.C. 6c(a)), by stating that is unlawful for any employee or agent of the Federal Government to use any information gained during the course of their employment "for personal gain to enter into": (a) a contract of sale of a commodity for future delivery (or option on such a contract); (b) an option (other than an option executed or traded on a national securities exchange registered pursuant to section 6(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78f(a)); or ''(C) a swap. It further provides a definition of "non-public information"; "knowing use"; "theft of non-public information". The detail is extensive.

4.3) Europe - MAD II – The whole truth

[71] www.cftc.gov/pressroom/events/amaf_qu_final
[72] https://www.ferc.gov/about/ferc-does.asp
[73] http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf

The Market Abuse Directive II ("MAD II") is the successor to the original MAD legislation that came into effect in 2003, and was implemented in the UK in 2005. This section will explore the fundamental differences of the original directive, to the incoming directive. MAD II is designed to create a rule book that is relevant at a European Union-wide level, creating a single rulebook for all member states. MAD II is supported by a separate piece of legislation, the Market Abuse Regulation ("MAR"). As mentioned in the introduction to this dissertation, there are several regulatory initiatives coming into effect most of these have an effect on transparency. The fundamental difference between MAD, Directive 2003/6/EC and the proposed MAD II and MAR, are that MAR directly mentions spot commodity markets and MAD II criminalises all aspects of insider dealing and market manipulation (market abuse). Both Proposals[74] deal with market abuse in its entirety; this includes other forms of market manipulation not merely insider trading. The Proposal states that the current regulation does not provide "a clear and binding definition of inside information in relation to commodity derivative markets"[75]. The MAR proposal[76] provides a lengthy discourse regarding the close relationship that is enjoyed by the derivative and commodity spot markets, section 3.4.1.2 states that: "it is possible for market abuse to take place across the markets[77]", but this discourse falls short of specifying insider dealing. Existing rules on transparency relate to the financial and derivative markets, not to the spot markets, as the latter markets are not financial in nature and therefore sit outside of this regulation which pertains to the financial markets. As stated elsewhere in this dissertation it is a well known fact that the "spot" and related derivative markets are interrelated, which creates quite a few concerns for regulators. The intention is not for the Regulation to directly oversee the spot markets. That said it is the intention that the Regulation will cover the transactions or behaviours in those spot markets. The

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[74] European Commission Proposal for a Regulation of the European Parliament and of the Council on insider dealing and market manipulation (market abuse), (2011), 2011/0295 (COD), 7

[75] European Commission Proposal for a Regulation of the European Parliament and of the Council on insider dealing and market manipulation (market abuse), (2011), 2011/0295 (COD), 7

[76] European Commission Proposal for a Regulation of the European Parliament and of the Council on insider dealing and market manipulation (market abuse), (2011), 2011/0295 (COD), 7

[77] European Commission Proposal for a Regulation of the European Parliament and of the Council on insider dealing and market manipulation (market abuse), (2011), 2011/0295 (COD), 7

discourse continues by stating that: "information can be abused before the issuer is under the obligation to disclose it. The state of contract negotiations, terms provisionally agreed in contract negotiations, the possibility of the placement of the financial instruments, conditions under which financial instruments will be marketed, or provisional terms for the placement of financial instruments may be relevant information for investors. Therefore, such information should qualify as inside information. However such information may not be sufficiently precise for the issuer to be under an obligation to disclose it. In such cases, the prohibition against insider dealing should apply, but the obligation on the issuer to disclose it should not apply."

4.4) REMIT

The purpose of this regulation is to eliminate abuse activities in the wholesale energy market, as the wholesale energy market includes both commodity and derivative markets.[78] Both are important to the energy and financial markets. These markets are now inter-related across the European Union and have an effect on both electricity and natural gas prices.[79] The definition noted in Article 2 is similar in context to the definition of "Insider Information" provided in MAD II, which again demonstrates the transparency that the EU wishes to create.

4.5) Exchanges and Self Regulation

Exchanges play an important part in the role of market surveillance; generally they all have sophisticated systems in place for monitoring abuse in "on exchange" trading. The exchanges that will be referred to in this section have been set out in section 2.7. As noted in Chapter 2, each commodity has its own market and as such each commodity will generally have its own exchange, or as

[78] Diego Leis, 'High Frequency Trading: Market manipulation and systemic risks from an EU perspective', 5
[79] *Ibid*

demonstrated in the table there are those exchanges that manage more than one commodity, largely due to the ever increasing interest in creating mergers between exchanges. For the sake of brevity only the main exchanges[80] will be discussed in this section. Each exchange manages the issues of market abuse, by using specialised systems for marker surveillance. For example the London Metal Exchange, a specialist team is responsible for monitoring trading on a daily basis; this is in order to ensure that it is fair and transparent. Members of the LME will report all proprietary and client trades on a confidential basis and the team will ensure that the trades have been executed in accordance with the exchange rules. This type of monitoring activity will take place on all the major exchanges.

In his article entitled the Self-Regulation of Commodity Exchanges[81], Craig Pirrong argues that although many scholars believe that laws against market manipulation are surplus to requirement due to the self regulation of exchanges; indeed these exchanges are not motivated to apply regulation as they will continue to make money regardless whether or not market manipulation takes place. Professor Pirrong continues with his argument against the assertion that self-regulation of exchanges is sufficient. He puts forward counter-arguments to the "theoretical arguments that assert the efficacy and first-best efficiency of self-regulation" (i) a failure to acknowledge that in most cases the costs of manipulation do not affect the exchange members but those external to the exchange as "manipulation harm inframarginal demanders", when the "wealth of exchange members depends only on how manipulation affects marginal demanders"; (ii) misjudges the poor effects of manipulation on the as it affects futures prices; (iii) "exaggerate the amount of competition between commodity exchanges; and (iv) ignores the problems relating to "collective action and rent seeking during manipulations impair the incentives of member-owned commodity exchanges to self-police. He concludes this statement by commenting that when all of these issues are considered, it would seem that regulations would employ less protection and deterrence against manipulative conduct.

[80] Refer to the table of exchanges in Chapter 1, section 1.7
[81] Stephen Craig Pirrong, "The Self-Regulation of Commodity Exchanges: The Case of Market Manipulation", (1995) Journal of Law and Economics 38:1, 142

Jonathan Lurie[82] suggests that

> "the reasons why the commodities exchanges have so rarely studied in either their development or their administrative and regulatory aspects are suggested by their basic nature as well as the lack of source material. The commodities exchanges, after all, were and remain private associations. Their key function is to settle mercantile disputes among the members quietly and quickly."

4.6) Manipulation and the economic affect

Professor Pirrong argues that manipulation has a negative effect on the economy "manipulation affects welfare and wealth distribution as well. There are deadweight losses due to the distortion in patterns of consumption, transportation, and storage. Manipulation also elevates cash prices both inside and outside the delivery market, so owners of stocks of the squeezed commodity profit, while consumers of these stocks (such as commodity processors) lose.

[82] Jonathan Lurie, Commodities Exchanges as Self-Regulating organisations in the late 19th Century, (1975), Rutgers Law Review 1107, 1111

Chapter 5

Review of instances of market abuse within the commodities markets

In the past few years there have been a significant number of high profile convictions for insider trading, both in the United Kingdom ("UK") as well as the United States of America ("US").

5.1) Regulatory Background

Historically, the commodities markets have benefitted from a light-touch regulatory regime. However, more recently, scrutiny has intensified in this market which also relies on the use of over- the-counter derivatives ("OTC") products as well as exchange traded derivatives products which are important to the industry for the purpose of transfer of ownership. The intention[83] of MAD was to prohibit insider dealing and market manipulation in financial instruments which are admitted to trading on a regulated market. Since the advent of MiFID, more financial instruments have been traded on additional venues, such as multilateral trading facilities (MTF's) and organised trading facilities (OTF's). Thus the increase in these trading venues has made monitoring of market abuse far more difficult than the previous regime of exchange trading. The UK relies on criminal sanctions in order to deter market abuse[84], these include: "(1) The common law crime of conspiracy to defraud to cover rigging a market; (2) the statutory offences of 'misleading statements' and 'market manipulation', re-enacted FSMA as 'misleading statements and practices'; and (3) separate legislation making insider dealing a criminal offence." (Alcock, 2002)

[83] Proposal, p.6, 3.4.1.1
[84] Alistair Alcock, 'Market Abuse', (2002) Company lawyer, 1

5.2) The issues

Most commodity derivative contracts are executed on exchanges or multilateral trading facilities (MTF), as such any trades executed in this manner are inherently screened for market abuse[85] however a significant number of contracts are negotiated over the counter (OTC) and these have been far less regulated, until recently. We are now seeing the introduction of regulation of the OTC markets on a global scale. In the US the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") has been introduced to deal with matters such as clearing, reporting, portfolio reconciliation amongst other things in order to ensure greater efficacy of regulation in the derivatives sphere.

5.3) Behaviours

Under the FSA rules of Market Conduct there are seven behaviours of market abuse, these include: Insider dealing; improper disclosure; Misuse of information; Manipulating transactions; Manipulating devices; Dissemination; Misleading behaviour and distortion. The behaviour that is central to this dissertation has been discussed in detail and will not be discussed in this chapter. The other behaviours will be dealt with on a group basis for the purposes of comparison.

5.4) Other forms of market manipulation

In order to create greater transparency across financial markets, regulators around the globe are now cracking down on the commodities markets. In the past these markets have enjoyed relative flexibility as well as a less restrictive regulatory environment. At the moment the much maligned Market Abuse Directive II is being discussed in Brussels, in minutiae. This directive follows on from the original MAD which came into force in 2005, originally directed towards securities and derivatives, but now broader, looking to include commodities as well. It is apparent that commodities markets cannot be regulated

[85] Cinquegrana, (n. 28), p. 12

in the same way as securities, and it is impossible to simply expand the rules to capture this asset class and its related instruments. So what is in store for commodity traders in the future, well quite simply Insider Trading will now be a criminal offence which can carry a prison tariff and / or an unlimited fine. The crux of this matter is that the commodity firms rely heavily on so-called insider information. Can commodity insider information be defined in the same way as that of securities?

5.5) Enforcement

In order for MADII to be effective it is clear that there needs to be greater co-operation between all member countries. The International Organisation of Securities Commission ("IOSCO") issued a report[86] in March 2009 which "focused on enhancing the ability to detect, enforce and deter manipulative and other abusive trading on commodity futures markets and on making recommendations with the objective of improving transparency in the underlying commodity markets." In concluding their article Christensen, Hall and Leuz[87] state that their "findings support the notion that the success of regulation depends critically on how regulation is implemented and enforced, and not just on how it is designed".

5.6) Recent cases of market manipulation

This final section will review recent cases of insider trading and market manipulation including some cases in the commodities market and the effect that this has had on the market as well as the regulators response. Over the past 10 to 15 years we have witnessed bankruptcies within commodity firms that have had a significant impact on the market. An example of this is Enron, in response to this failure the US introduced the now rather maligned Sarabanes-Oxley regulation came into force in the US in 2002, to prevent further failures. Around the same time there were other failures such as

[86] Task force on Commodity Futures Markets, Final report, Technical Committee of the International Organisation of Securities Commissions (2009) 14
[87] Hans B Christensen, Luzi Hail, Christiaan Leuz, 'Capital-Market Effects of Securities Regulation: The Role of Implementation and Enforcement' (2010) 36

Parmalat SpA and certain other commodity firms. Whilst these are not related to insider trading they are examples of market manipulation which has had an adverse effect on the market. Also the regulators have seen fit to create an enforcement action to deter others from indulging in this activity. The first case to be reviewed is one of the most recent cases of market manipulation where a commodities trading company has been fined by global regulators.

5.6.1) Panther Energy LLC

This example of high frequency trading (HFT) is only a few months old but demonstrates the close relationship that global regulators are now enjoying. At the time of legal cutover[88], the FCA announced that they were going to become a tough regulator and take contraventions seriously. In July 2013 the FCA fined a US based Trader by the name of Michael Corsica for deliberately manipulating the commodities markets through High Frequency Trading ("HFT"). This manipulative action is also known as "layering" and "spoofing".

> "a wide variety of highly competitive trading strategies used by securities market intermediaries who use an automated system of algorithmic trading and ultra-fast computers in order to hold securities for a fraction of a second and then transact to capture the spread", or as the "use of high-speed computer algorithms to automatically generate and execute trading decisions for the specific purpose of making returns on proprietary capital"[89]

Essentially this is not illegal but according to reports from the FCA and Reuters; Corsica and his firm, Panther Energy Trading LLC, were executing orders and then cancelling them, which in turn resulted in misleading the market but in addition they also profited from this situation. There are a number of interesting points in this case, the FCA have fined a US

[88] Legal cutover the FSA ceased to exist and was replaced by the Prudential Regulatory Authority (PRA) and the FCA.

[89] Diego Leis, 'High Frequency Trading: Market manipulation and systemic risks from an EU perspective', 18

based commodities trader and the CFTC have also taken action against the trader and the firm. This not only demonstrates the inter-connectivity of the markets, but it also demonstrates the commitment of global regulators to work together in order to create a more robust system.

5.6.2) Allegations of Price Fixing against BP, Shell and other oil companies

In May 2013 many newspapers and news agencies[90] revealed allegations that certain oil majors had been involved in price fixing of oil prices, manipulation which had taken place over a number of years. At the time the Serious Fraud Office[91] (the "SFO") stated that it would consider pursuing charges against the perpetrators of this activity. Whilst "price-fixing" forms part of European Competition Law (or in the US this is known as "Anti-Trust), it is a form of market manipulation and therefore is worth mentioning in this context. In closing it has to be considered that those who are closest to this type of information could be guilty of insider dealing on the basis that they have "rigged" the market to make money and therefore could buy shares in one of the oil companies involved in the alleged rigging.

5.6.3) Libor Scandal

Another recent scandal is that of Libor which again demonstrates the way in which global authorities are co-operating to ensure that market manipulation is eradicated. The case of Libor is interesting as it also encompasses European Competition law[92]. In this instance a number of banks were accused of "fixing" the Libor rate in order to reduce competition. The case is ongoing, however it is understood from newspaper reports that the inter-dealer broker ICAP[93] is in talks with the CFTC concerning a multi-million pound fine. According to a report by the BBC[94] this issue dates back seven years to 2005.

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[90] http://www.bbc.co.uk/news/uk-politics-22540650; http://www.ft.com/cms/s/0/2d68dfd8-bd60-11e2-890a-00144feab7de.html#axzz2ezuuWRDr
[91] http://www.theguardian.com/law/2013/may/16/sfo-alleged-price-fixing-oil
[92] As noted in 5.6.2
[93] http://www.ft.com/cms/s/0/d2aa02ac-1c87-11e3-8894-00144feab7de.html#axzz2ezuuWRDr
[94] http://www.bbc.co.uk/news/business-18671255

LIBOR is considered to be a crucial interest rate in the financial world. In reports released in the financial press late during the week of 7 September 2013, European regulators stated that the management and control[95] of LIBOR would remain in London and not be moved to Brussels. As with the oil price fixing it is important to mention different forms of manipulation.

Manipulation of the commodities market has taken place over a number of years and in the next part of this section, some older instances will be reviewed.

5.6.4) Metallgesellschaft

Metallgesellschaft AG (MG)[96] was a German commodities broker, which during the summer of 1995 settled a complaint with the CFTC, following its attempt to become a major player in the US oil market. According to the CFTC, MG Refining & Marketing (MGRM)

> "sold illegal off-exchange energy product futures contracts to more than 100 independent gasoline stations and heating oil distributors throughout the United States. The illegal futures contracts were part of MGRM's overall energy contract business, which MGRM hedged barrel-for-barrel with near-term futures contracts, including NYMEX futures contracts and over-the-counter swaps."

There is insufficient time to delve into the intricacies of this case, however it does demonstrate the need for stronger corporate governance and provides an indication of how insider dealing in the commodities markets might be accomplished.

5.6.5) Amaranth

[95] http://www.ft.com/cms/s/0/137c2e5e-1b0c-11e3-b781-00144feab7de.html#axzz2ezuuWRDr
[96] Ed Krapels, 'Re-examining the Metallgesellschaft affair and its implications for oil traders', (2001), http://ogi.penmet.com/Articles/print_screen.cfm?Section=Archives&Publication_ID

Amaranth[97] was a hedge fund which operated in multi-strategies, but by 2006 a large proportion of the investment had been devoted to natural gas. Hilary Till provides the following summary of the issues observed in this case, these relate specifically to the commodities market:

(1) "Natural gas offered funds a potentially alluring combination of scalability and volatility, and so has attracted a number of non-traditional financial participants during the past few years;
(2) Commodity derivatives markets are relatively small and therefore it is easy for these markets to be overwhelmed; and
(3) The US regulatory umbrella, covering energy trading has had a noteworthy gap in coverage"

5.6.7) Warehousing Probe

An article in the Financial Times[98], as recently as early August 2013 states that the CFTC is conducting a probe into warehousing activities of a number of major organisations. The article states that subpoenas have been circulated to the likes of Goldman Sachs, JP Morgan[99], and Glencore, and have issued "Do Not Destroy" letters relating to certain documentation. It is alleged in this article that Goldman Sachs have been accused of artificially increasing aluminium prices, this has been vociferously denied by the bank. It is difficult to ascertain the foundation of this issue as there appears to be little or no information concerning this matter, on the CFTC website.

[97] Hilary Till, 'The Amaranth Collapse: What happened and what have we learned thus far?' (2007) EDHEC, 3
[98] http://www.ft.com/cms/s/0/b8917ace-037f-11e3-b871-00144feab7de.html#axzz2f2nISAVS
[99] JP Morgan acquired Henry Bath Metals Warehouses following the acquisition of RBS Sempra Commodities in 2010

Conclusion

This dissertation has merely scratched the surface regarding the issue of insider dealing in the commodities market; the subject matter created an extremely wide and varied remit. Whether or not criminalising this activity will become a feasible deterrent remains to be seen. The final part of this dissertation demonstrated the various examples of market manipulation in the commodities market and some of the cases bordered on insider trading. In theory insider trading is possible; in reality it is unlikely to take place in the same manner as it does in the securities market. Bearing in mind that it is generally individuals who are guilty of insider trading off the back of information gained in an environment of trust, this is exploited for their own personal gains.

Criminalising the act of insider dealing whether in the commodities market or the securities market will only be effective if the activities are monitored via surveillance systems. The fact remains that detecting insider dealing in commodities will be difficult; detecting instances of market abuse is definitely an issue that should be pursued and punished. As has been illustrated this does have an effect on the markets which will eventually find its way to the consumer.

As illustrated throughout this dissertation there are occurrences of market abuse on virtually a daily basis, once again the financial world has been rocked with a number of scandals which proves that the regulation currently in place is not yet robust enough to prevent these actions from taking place. There is a fine balance between enough regulation and commercialism. However, the commodities market is an entirely different market to that of securities. It remains vital that regulators who understand this market are trained to take on the onerous task of monitoring it more closely. Whilst balancing the tightrope of regulation and commercialism, perhaps it is time that the financial sector took more responsibility for their own corporate governance and agreed amongst them to manage the risk more effectively. This seems unlikely so for now the regulators are left with no choice but to enhance regulation, making it more draconian and employ closer co-operation across borders. Finally,

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