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Historic Decline in Oil May Trigger Additional Disclosures by FCMs and Product Restrictions by Broker-Dealers

Oil Futures Markets

On April 20, 2020, a combination of a deteriorating global economy brought on by the Coronavirus Disease 2019 (COVID-19) pandemic, a price war between Russia and Saudi Arabia, lack of demand, and significantly, a lack of storage capacity, produced a collapse in the price of the West Texas Intermediate light, sweet crude oil (WTI) May 2020 futures contract. At one point the futures price fell to a negative $40/barrel, with prices in related cash markets reaching negative $54/barrel. Unlike Brent crude, which has various delivery locations and did not experience a comparable price decline, the WTI futures contract has only one delivery location, in Cushing, Oklahoma. CME Group Inc (CME) the owner of the New York Mercantile Exchange (NYMEX), one of the exchanges on which WTI futures are traded, was criticized by some market participants for the price declines into negative territory, and responded through its chairman and CEO that the decline in the May contract accurately reflected price discovery and, as such, the market had performed just as it should.

Exchange-listed futures contracts expire on precise dates and trade in a time-dependent relationship to the cash market on which these contracts are based. A futures market in which longer-dated contracts trade at a premium to contracts expiring earlier, or to the cash price itself, is said to be in contango. Participants using futures as a substitute for positions in the cash market essentially pay a premium to

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maintain such positions in a futures market in contango by incurring higher prices each time a position is rolled forward. Futures markets that trade at higher levels of contango are sometimes said to be in super contango. Recent events in the WTI futures market have been described in these terms by a number of market participants.

Futures traders are assumed to understand that losses can exceed the amount deposited as margin due to the highly leveraged nature of futures trading. Prior to April 20, 2020, however, some market participants may not have appreciated that futures can trade at negative prices. Furthermore, market participants collateralizing their futures positions by paying the full value of the position may have thought that they could not face additional risk beyond the full value of the contract. However, as Carl Gilmore, a noted industry expert, recently stated: “Negative oil prices have thrown the concept of full collateralization right out the window.” The historic decline in oil futures may cause futures commission merchants to re-examine disclosures mandated by CFTC and NFA rules, and perhaps supplement these with additional disclosures and descriptions tailored specifically for certain products. Such disclosures and descriptions may include the possibility that commodities can trade at negative prices, thereby increasing risk of loss, as well as the fact that “fully collateralized” contracts do not mean that losses cannot exceed the notional value of a contract.

United States Oil Fund LP

The United States Oil Fund, LP (USO) is an exchange-traded product (ETP). Prior to April 17, 2020, USO’s investment structure was designed to reflect daily changes in percentage terms of the spot price of WTI delivered at Cushing, Oklahoma, as measured by daily changes in the price of the futures contract on WTI traded on the NYMEX front-month contract, except when the near-month contract was within two weeks of expiration, in which case the benchmark price was measured by the next month’s contract. The recent volatility and price decline in near-term WTI contracts has put pressure on the fund, resulting in a series of changes to its investment structure designed to reduce exposure to near-month contracts.

On April 17, 2020, USO disclosed in a filing with the SEC that it was changing the investment structure of the fund to invest approximately 80% of its portfolio in WTI futures contracts on the NYMEX and ICE Futures exchanges in the front-month contract and approximately 20% of its portfolio in WTI futures contracts on the exchanges in the second-month contract, except when the front-month contract is within two weeks of expiration, in which case the futures contracts USO holds would be rolled into the second-month contract and third-month contract. While USO had been rolling its futures positions forward over a four-day period, the fund disclosed in an SEC filing on April 27, 2020, that beginning with the monthly roll occurring in May 2020, its positions in WTI futures contracts and other oil-related investments will roll over a 10-day period beginning on May 1, 2020.

Although USO had already rolled out of the May 2020 WTI contract when the price of that contract went negative on April 20, 2020, the fund nonetheless remained exposed to the potential for significant losses, since it was trading only the next two-nearest contracts at a time when the market was considered to be in super contango. As near-term contracts remained under historic market pressure, on April 21, 2020, USO filed with the SEC a further amendment to its investment structure, pursuant to which it would begin investing in the WTI futures contracts expiring in June 2020, July 2020, and August 2020. Only days later, on April 24, 2020, this change in investment structure was superseded by another filing extending to September 2020 the futures contract months in which the fund invests. At the same time, USO disclosed that it may invest in futures contracts in any month available on the NYMEX and ICE Futures exchanges, or in any other permitted investment, without further disclosure.

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In an SEC filing on April 27, 2020, the fund disclosed that it was once again extending the fund's longest-dated futures positions through the June 2021 contract. The fund further disclosed that this was based on market factors and risk mitigation, as well as correspondence from CME regarding accountability levels and position limits. USO stated that in the current market and regulatory environment, significant tracking deviations can be anticipated to occur beyond the differences that had historically existed when the primary investment was the front-month WTI futures contract, and further, that the types of permitted investments that USO makes as a result of regulatory and position limits are experiencing and will likely continue to experience greater effects from contango. USO also stated that investors in the fund should expect that there will be continued deviations between the performance of USO's investments and the fund's benchmark, that USO may not meet its investment objective, and that the inability to closely track the fund's benchmark and the impact of higher levels of contango will impact the performance of USO and the value of the fund's shares.

USO has been a widely held product in retail securities brokerage accounts for years. While some retail firms have enhanced procedures and/or purchase restrictions in place for inverse or leveraged ETPs, in some cases restricting purchases to unsolicited orders only and requiring signed investor letters, these procedures and restrictions generally have not applied to non-inverse and unleveraged ETPs, such as USO. In light of the historic recent events, however, some firms may now be considering whether to implement additional procedures or purchase restrictions for other ETPs as well.

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