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The Copper King: An Empire Built On Manipulation

The commodities market has grown in importance since the 1990s, with more investors, traders and merchants buying futures, hedging positions, speculating and generally getting the most out of the complex financial instruments that make up the commodities market. With all the activity, people dependent on futures to remove risk have raised concerns over large speculators manipulating the markets. In this article we'll look to the past for one of the biggest cases of market manipulation in commodities and what it meant to the future of futures

The 5%

There is still a sense of mystery surrounding Yasuo Hamanaka, a.k.a. Mr. Copper, and the magnitude of his losses with the Japanese trading company Sumitomo. From his perch at the head of Sumitomo's metal-trading division, Hamanaka controlled 5% of the world's copper supply. This sounds like a small amount, since 95% was being held in other hands. Copper, however, is an illiquid commodity that cannot be easily transferred around the world to meet shortages. For example, a rise in copper prices due to a shortage in the U.S. will not be immediately canceled out by shipments from countries with an excess of copper. This is because moving copper from storage to delivery to storage costs money, and those costs can cancel out the price differences. The challenges in shuffling copper around the world and the fact that even the biggest players only hold a small percentage of the market made Hamanaka's 5% very significant.

The Setup

Sumitomo owned large amounts of physical copper, copper sitting in warehouses and factories, as well as holding numerous futures contracts. Hamanaka used Sumitomo's size and large cash reserves to both corner and squeeze the market via the London Metal Exchange (LME). As the world's biggest metal exchange, the LME copper price essentially dictated the world copper price. Hamanaka kept this price artificially high for nearly a decade leading up to 1995, thus getting premium profits on the sale of Sumitomo's physical assets.

Beyond the sale of its copper, Sumitomo benefited in the form of commission on other copper transactions it handled, because the commissions are calculated as a percentage of the value of the commodity being sold, delivered, etc. The artificially high price netted the company larger commissions on all of its copper transactions.

Smashing the Shorts

Hamanaka's manipulation was common knowledge among many speculators and hedge funds, along with the fact that he was long in both physical holdings and futures in copper. Whenever someone tried to short Hamanaka, however, he kept pouring cash into his positions, outlasting the shorts simply by having deeper pockets. Hamanaka's long cash positions forced anyone shorting copper to deliver the goods or close out their position at a premium.

He was helped greatly by the fact that, unlike the U.S., the LME had no mandatory position reporting and no statistics showing open interest. Basically, traders knew the price was too high, but they had no exact figures on how much Hamanaka controlled and how much money he had in reserve. In the end, most cut their losses and let Hamanaka have his way.

Mr. Copper's Fall

Nothing lasts forever, and it was no different for Hamanaka's corner on the copper market. The market conditions changed in 1995, in no small part thanks to the resurgence of mining in China. The price of copper was already significantly higher than it should have been, but an increase in the supply put more pressure on the market for a correction. Sumitomo had made good money on its manipulation, but the company was left in a bind because it still was long on copper when it was heading for a big drop.

Worse yet, shortening its position - that is, hedging with shorts - would simply make its significant long positions lose money faster, as it would be playing against itself. While Hamanaka was struggling over how to get out with most of the ill-gotten gains intact, the LME and Commodity Futures Trading Commission (CFTC) began looking into the worldwide copper-market manipulation.

Denial

Sumitomo responded to the probe by "transferring" Hamanaka out of his trading post. The removal of Mr. Copper was enough to bring the shorts on in earnest. Copper plunged, and Sumitomo announced that it had lost over $1.8 billion, and the losses could go as high as $5 billion, as the long positions were settled in a poor market. They also claimed Hamanaka was a rogue trader and his actions were completely unknown to management. Hamanaka was charged with forging his supervisor's signatures on a form and was convicted.

Sumitomo's reputation was tarnished, because many people believed that the company couldn't have been ignorant of Hamanaka's hold on the copper market, especially as it profited from it for years. Traders argued that Sumitomo must have known, as it funneled more money to Hamanaka every time speculators tried to shake his price.

Fallout

Sumitomo responded to the allegations by implicating JPMorgan Chase and Merrill Lynch. Sumitomo blamed the two banks for keeping the scheme going by granting loans to Hamanaka through structures like futures derivatives. All of the corporations entered litigation with one another, and all were found guilty to some extent. This fact hurt Morgan's case on a similar charge related to the Enron scandal and the energy-trading business Mahonia Ltd. Hamanaka, for his part, served the sentence without comment.

Manipulation Today

Since the copper-market manipulation, new protocols have been added to the LME to prevent a similar cornering of the market. It is nearly impossible for long-term manipulation like Hamanaka's to occur in today's market, as there are more players and much more volatility with longs and shorts facing off daily with real-time price quotes flashing across the battleground. In fact, the commodities market faces the opposite problem - short-term price spikes brought about by speculators with deep pockets. The bizarre two-day spike in the price of cotton in March 2008 is an example of this problem.

As the kinks are being worked out of the new electronic commodities exchange, Intercontinental Exchange (ICE), many loopholes have been opened up. The use of swaps and synthetic derivatives by hedge funds and institutional buyers wanting to exceed CFTC and exchange limits has made spotting commodities manipulation harder. Unfortunately, this means that futures have lost some of their value as a hedge for merchants against market risk and price fluctuation. Investors and merchants can only hope that the ICE will continue to improve and make market manipulation in the commodities truly a thing of the past.

Descriptive Questions

i. Describe why it might be possible to make speculative profits by trading in the primary (physical) markets for copper.

ii. Describe the market conditions necessary and the actions that might be taken in order for a single trader to successfully 'corner' the market, using the Sumitomo affair to illustrate your description.

iii. Describe the potential components of Sumitomo's during these events.

iv. Comment on why losses might now be more than twice the initial estimate.

v. Explain four key internal(risk management) controls that would have helped mitigate the losses you identified in parts (iii) and (iv)