From: Patty Lovera <plovera@fwwatch.org>
Sent: Monday, April 26, 2010 9:07 PM
To: secretary <secretary@CFTC.gov>
Subject: comment on Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations
Attach: Food & Water Watch Speculative Position Limits Comment 4-26-2010.pdf; ATT00002.htm

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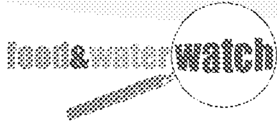
Please find attached a comment on Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations from Food & Water Watch. Thank you for your consideration of these comments.



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April 26, 2010

David Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street NW
Washington, DC 20581

Re: Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations

Transmitted electronically: secretary@cftc.gov

Dear Mr. Stawick:

On behalf of the non-profit consumer organization Food & Water Watch, I respectfully submit the following comments on the Commodity Futures Trading Commission notice of proposed rulemaking on Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations (75 Fed. Reg. 16 4144-4172). Food & Water Watch commends the Commission for promulgating fair, sensible safeguards to reduce the impact that excess speculation can have on prices, volatility, price discovery and the ability of legitimate, *bona fide* commercial commodity futures traders to manage their business risks.

The proposed rule takes important first steps toward ensuring that commodity futures markets are not distorted by excessive speculation, part of the core mission of U.S. commodity market regulators for the past 75 years. Over the past several years, the role of excess speculation in contributing to rising energy prices and price volatility has been documented by numerous academic studies.[1]

Strong Position Limits Necessary to Prevent Excess Speculation

Over the past decade, the total volume of commodity futures trading increased more than five-fold.[2] The number of futures and futures options contracts for all commodities (including oil and metals) traded on regulated exchanges grew from 630 million contracts

[1] *See*, for example, Eckaus, R.S. Massachusetts Institute of Technology Center for Energy and Environmental Policy Research. "The oil price bubble really is a speculative bubble." June 2008; United Nations Conference on Trade and Development. "The Global Economic Crisis: Systemic Failures and Multilateral Remedies." UNCTAD/GDS/2009/1. 2009.
[2] 74 Fed. Reg. 12285.

in 1998 to 3.75 billion contracts in July 2008.[3] Much of the increase in commodities futures trading was the result of Wall Street investors rather than commercial firms hedging their risk. Preventing excess speculation in energy commodities helps consumers at the gasoline pump and with their home heating bills. But energy is a considerable cost for farmers, food processors, food distributors and grocery retailers, so high energy prices driven by speculation can hurt consumers at the supermarket as well. In 2008, retail food prices rose by nearly 7 percent, the highest rate of food inflation since 1980.[4]

While Food & Water Watch commends the Commission for establishing position limits for energy commodities, it is important that position limits be strong enough to actually prevent excess speculation from distorting the commodities markets. Position limits set a cap on the number of agricultural futures contracts (either a buy or a sell position) a commodities trader can take. These limits were designed to keep investors without an interest in the physical commodity from dominating the marketplace, without limiting necessary trading by grain elevators, food processors and meatpackers. Speculative position limits were first established in 1936 to prevent excess speculation from creating extreme volatility in agricultural prices.[5] Position limits currently are applied to corn, wheat, oats, cotton, soybeans, soybean oil and soybean meal.[6] Expanding the use of mandated position limits to energy contracts can reduce excess speculation, price escalation and volatility in the energy sector. The Commission should develop additional position limits for other "soft" agricultural commodity contracts like cocoa and coffee to prevent these commodities from becoming the final market for excess speculative investment.

Food & Water Watch concurs with many observers that the position limits proposed by the Commission may be too high and recommends that the Commission reduce the limits for non-commercial investors.

Exemptions from Position Limits Should be Narrow and Limited to Bona Fide Commercial Traders

Additionally, Food & Water Watch supports efforts to close the exemptions to position limits that have been built up over the past two decades. Before the mid-1980s, commodity traders were divided between commercial traders that had a physical interaction with the commodity they were trading — baking companies buying wheat or farmers selling it — or non-commercial traders that had no interest in the physical commodity but provided liquidity by taking the opposite position to the commercial traders — buying grain futures from elevators and selling contracts to food processors, for example.[7] Most of these non-commercial speculators in commodity markets were

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[3] Commodity Futures Trading Commission. "Staff Report on Commodity Swap Dealers & Index Traders with Commission Recommendations." September 2008 at 8.
[4] U.S. Bureau of Labor Statistics. "Consumer Price Index: December 2008." January 16, 2009 at 2.
[5] 74 Fed. Reg. 12283.
[6] *Ibid.*
[7] CFTC 2008 at 8.

once smaller agricultural futures traders that had knowledge of agriculture and the grain marketplace.[8]

Non-commercial traders were subject to limits on the number of contract positions they could legally take on the regulated futures markets. Between the early 1990s and the 2008 food crisis, the Commission blurred the distinction between those with a physical interest in the commodity and those with financial interest in the commodity, treating large, purely speculative investment banks and money managers the same as farmers, grain elevators and food processors. The regulations provided expanded exemptions to speculative position limits beyond just farmers and grain milling companies to include many managed money firms and commodity swaps dealers that were managing their financial risks.[9] By 2006, the non-traditional hedgers that were granted position limit exemptions represented a significant share of the long-term futures contracts.[10]

At the same time, the more complex financial derivatives — involving interest rate or currency swaps — became more common. The Commission began to view agricultural futures contracts as just another financial instrument, and effectively dismantled the safeguards that prevented excess speculation in agricultural commodities. In 1987, the Commission decided that many of the financial companies that were operating in the futures markets — especially in financial futures contracts — were effectively hedgers, just like grain milling companies or grain elevators, and should be considered commercial traders.[11] In 1991, the Commission exempted commodity-based swaps dealers that used real commodity contracts to sell commodity index funds on the over-the-counter (OTC) swaps markets.[12] These changes effectively exempted many financial firms that traded on the commodity futures markets from any position limits and allowed large financial speculators to dominate commodity markets.

Blurring the distinction between physical hedgers and financial investors as well as allowing an unregulated swaps market to thrive encouraged more investors to enter the commodities market. Managed money funds could and did trade and invest in both the regulated exchanges and the OTC market. Investment banks were hedging their investments in financial derivatives with agricultural futures contracts. The weakening of position limits allowed more Wall Street firms to trade and hold large pools of agricultural commodity futures contracts. Both of these deregulatory factors allowed a tidal wave of new investors and funds into the agricultural commodity markets which significantly increased demand – artificial demand – for physical commodities, which led to inflationary price pressures.[13]

The proposed exemptions from the proposed energy position limits include *bona fide* commercial hedgers as well as limited risk management exemptions for swaps dealers

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[8] Hagstrom, J. "Crowded commodities markets." *National Journal*. June 7, 2008 at 41.
[9] *Ibid*.
[10] 74 Fed. Reg. 12285.
[11] CFTC 2008 at 13-14.
[12] CFTC 2008 at 14.
[13] Masters, M.W. and A.K. White. "The Accidental Hunt Brothers." July 31, 2008 at 12.

that provide liquidity to the futures contract markets. Food & Water Watch supports narrowing exemptions to position limits. While swaps dealers provide necessary liquidity to the commodities markets, even limited risk management exemptions must be carefully monitored so that the exemption is designed to provide counter-party liquidity to commercial hedgers and not an avenue for managed money, index funds, and other passive investors to evade position limits. To that end, the disclosure and reporting requirements enumerated in the proposed rule are a good first step, but the Commission should rigorously police the recipients of the swaps exemption to ensure that these exemptions are not used as a blanket immunity from position limits for speculative swaps customers.

The Commission Should Curtail the Impact of Passive and Index Investors on Futures Markets

When the housing market began to implode in 2007, investors began to move into the commodity market to diversify their portfolios, especially by moving into a market that was not evaporating in value. These investors were treating commodities as another type of asset, just like investing in stocks, bonds or real estate.[14] The rise in new investors drove up food prices for consumers. Dan Basse, president of AgResources research firm, told the *New York Times* that "The cost from the farm to the grocer is elevated because of the volatility from these [index investment] funds. It will raise the cost for everybody, including the consumer."[15]

To gain access to the commodity markets' appreciating value, Wall Street investment banks developed commodity index funds that simulated investing directly in the commodity markets. Index fund traders represent institutional investors like pension plans and university endowments that have long-term investment goals, so these funds employ a buy-and-hold strategy commonly used on the stock market.[16] The long-term index fund investment horizon assumes the value of the commodities contracts will steadily rise over time. As a result, instead of both buying and selling commodity futures contracts, the funds overwhelmingly took what are known as long positions. Index funds represent a large portion of all long positions on the commodity markets. Index funds held about $200 billion in long commodity positions in March of 2008 – more than a third of the $568 billion total long positions.[17]

Importantly, the long-hold focused institutional investors can push prices higher because these participants are not interested in selling their contracts for any price.[18] Having significant portions of the market unavailable for sale puts upward pressure on the remaining contracts, as more bidders are competing for fewer contracts for sale. For food

[14] Kass, D. CFTC Surveillance Team. CFTC Agricultural Markets Roundtable at 46.
[15] Barrionuevo, A. and J. Anderson. "Wall Street is betting on the farm." *New York Times*. January 19, 2007.
[16] Masters and White at 10.
[17] Epstein, G. "Commodities: Who's behind the boom?" *Barron's*. March 31, 2008.
[18] Coyle, T. National Grain and Feed Association. CFTC Agricultural Markets Roundtable at 176-7.

and agricultural contracts and products, these indefinitely long-term investments amount to "virtual hoarding" of agricultural products positions.[19]

Although the number of index fund traders is small, on average they take very large positions in the commodities markets — sometimes 10 times higher than non-index traders.[20] The four largest financial swaps dealers (Goldman Sachs, Morgan Stanley, JP Morgan and Barclays Bank) controlled an estimated 70 percent of commodity index fund trading in 2008.[21] Commodity index funds investments surged during the past five years. Investments in commodity index funds grew 20-fold from $13 billion in 2003 to $260 billion in March 2008.[22]

Commodity index fund investment in agricultural commodities rose sharply at the same time world food prices surged. Index fund investments in corn, soybeans, wheat, cattle and hogs has risen nearly five-fold from $10 billion in 2006 to $47 billion in 2008.[23] Index funds or investors can represent a significant chunk of the agricultural futures market. Between January 2007 and March 2008, index investment in all agricultural commodities represented nearly a third of the investments in these commodity futures contracts.[24] For many food commodity futures contracts, index funds purchases represented more than half the futures contract purchases. Between January 2003 and July 2008, four-fifths of live cattle and wheat contracts (80 percent and 79 percent, respectively), three-quarters of lean hogs contracts (77 percent), two-thirds of soybean contracts (66 percent) and nearly half of corn contracts (48 percent) were purchased by index funds.[25]

This dominance by index fund purchasers effectively controlled large portions of food staples as global prices were rising. In 2007, index funds effectively purchased more than a third (36.6 percent) of the soybean crop and three-fifths (62.3 percent) of the wheat crop.[26] In 2008, index funds controlled nearly half (48.2 percent) of the wheat harvest, nearly a third (30.8 percent) of the soybean harvest and one-fifth (19.1 percent) of the corn harvest.[27] The U.S. Senate Permanent Subcommittee on Investigations reported that index investors in the wheat market rose seven-fold from 30,000 contracts a day in 2004 to 220,000 contracts a day in mid-2008 and this surging investment drove up the cost of wheat.[28]

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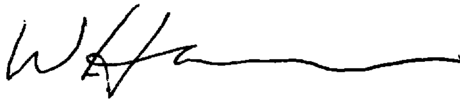
[19] Hagstrom at 43.
[20] UNCTAD. "The Global Economic Crisis" at 31.
[21] Masters and White at ii.
[22] Stewart, S. and P. Waldie. "Feeding frenzy." *Toronto Globe and Mail*. May 31, 2008.
[23] Young, J.E. International Food Policy Research Institute. "Speculation and world food markets." *IFPRI Forum*. July 2008 at 9. Includes U.S. market investments only.
[24] Kass, D. CFTC Surveillance Team. CFTC Agricultural Markets Roundtable at 52-53.
[25] Masters and White at 19.
[26] Epstein 2008.
[27] National Agricultural Statistics Service data; Masters and White at 16.
[28] U.S. Senate Permanent Subcommittee on Investigations, Committee on Homeland Security. "Excessive Speculation in the Wheat Market." June 24, 2009 at 2 and 5.

Conclusions

Curbing excess speculation in commodity markets can protect consumers in the United States and worldwide. The proposed position limits on energy products are a strong first step in restoring commodity futures markets to their risk management and price discovery purposes. These vital market functions can only work efficiently with strong regulatory safeguards. Well-regulated commodity markets prevent market manipulation and fraud as well as offer transparent price information to buyers and sellers. The Commission should also act decisively to prevent passive index funds from overwhelming futures markets. Strong position limits with limited, appropriate exemptions for *bona fide* commercial hedgers can prevent these markets from being distorted by vast inflows of speculative funds.

Sincerely,



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