PROPOSED TRADING LIMITS

RIN 3038-AD and 3038-AD16
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The proposed review of the trading limits on commodities as shown by the Wall Street Journal article of January 14, 2011 is not only timely and necessary, it is critical to our national economy. I will cover my comments based on crude oil futures and the petroleum section but the logic does apply to all commodities.

The common complaint is that the speculators are driving the price of crude oil in the Future's Market. This is only possible by the regulations that have been put in place originally and expanded over time to increase activity. The overlapping regulations covering various hedges and swaps have compounded and increased the activity beyond what was originally anticipated. Limiting the volume that speculators may carry is not going to improve or correct the misuse in the system. There is a better way and it needs to be acknowledged and implemented.

The underlying problem in the Futures Market can be traced to the low margin required to hold future contracts. The low margin and the overlapping regulations allow participants tremendous leverage to hold and trade crude oil and petroleum contracts. The margins required are further diluted with credit or offsetting positions that increases the leverage even more. The best example of leveraged positions was recently disclosed as a small gold trader. (WSJ 1/28/2011) Daniel Shak's $10 million hedge fund held gold contracts valued a more than $850 million or more than 10% of the main US futures market. How was this possible? The answer is obviously low margin and offset credit.

The margin level on the purchase of crude oil and petroleum contracts needs to be increased to 50% of the underlying value for contracts other than the spot month. This margin must be in the form of cash only without any credit consideration or offset positions and adjusted as the price changes from day to day. The volume held by speculators would then be governed by the cash investment available. The practical approach to implement this change and avoid major disruptions in the market would be to program this change in gradual steps over three or six months.

The futures market for crude oil and petroleum was based on the perceived need for price discovery. If this is still the basis for the futures market, it can be answered under the higher margin proposal. Prior to the futures market the prices were established by contractual arrangements between the producers and purchasers of crude oil and by industry competition for petroleum products. The futures market then replaced and set a level for price negotiations between buyers and sellers. That price level has been distorted by the low margin requirements that allow huge leveraged positions of traders and speculators.

It is still thought incorrectly by some that the price of crude oil is set by OPEC or by ExxonMobil and the other major oil companies. The price of crude oil then drives the price of gasoline and other petroleum products. If they don't set the price of crude oil, then who does? The answer is obviously the Wall Street traders and the futures market through "price discovery". Then the question is why do traders that do not produce or use a single barrel of crude oil set the price for the nation and the world?

The distortion created in the economy by the leveraged misuse and low margins of commodity trading reaches much further than the price of crude oil and petroleum products. The number and size of the hedge funds now in operation compete with banks and other established institutions for available investment capital. The hedge funds use a large portion of their invested capital to trade in the commodity markets rather than in fixed investment opportunities. Banks are then criticized for not making loans to business when their deposits are reduced by preference of investors for returns promised by hedge funds. A correction to the margins for commodity trading should help balance the placement investment capital. The low margins have created far reaching distortions in the national economy.

The complaint that will be voiced against increasing the margins on commodity trading will be that the commodity trading will just move offshore or to Europe. There is already trading in other parts of the world that follow the markets in the USA. The security of trading in the USA market does influence investors of the hedge funds that now drive the market. Logic is that the same volume and investment would not move offshore when the margins are increased. Margins increases are likely to follow in other markets after established in the USA markets.