INSTITUTE FOR AGRICULTURE AND TRADE POLICY

Comments on Commodity Futures Trading Commission Rulemaking on Position Limits for Derivatives
Proposed Rule 76 FR 4752-4777 -- RIN 3038-AD15 and 3038-AD16

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The Institute for Agriculture and Trade Policy (IATP) is a non-profit, 501.c3 non-governmental organization, headquartered in Minneapolis, MN with offices in Washington, D.C. Our mission states, "The Institute for Agriculture and Trade Policy works locally and globally at the intersection of policy and practice to ensure fair and sustainable food, farm and trade systems." To carry out this mission, as regards commodity market regulation, IATP has participated in the Commodity Markets Oversight Coalition (CMOC) since 2009, and has submitted several comments on CFTC rulemaking, most recently a November 26, 2010 comment on the proposed definition of "agricultural commodity" for the purposes of implementing Title VII of The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act").

When farmers began to contact IATP in the spring of 2008 to ask why their local elevators were no longer accepting forward contracts on their grain and oilseed production, and why rural bankers were not lending to the elevators to enable forward contracting, we discovered that orthodox agricultural economic explanations of futures and options market operations no longer sufficed. Traditional price formation remains vulnerable to non-fundamental factors to such an extent that futures prices may no longer be reliable benchmarks for forward contracting. For example, financial "innovations" such as High Frequency Trading algorithms, drive, and we believe distort, price formation for the commodity producers and users that the markets are supposed to serve.[i]

Our work in commodity market regulation is dedicated to preventing the price distortion that has damaged farm cash flow management capacity and food security, particularly for net food import dependent developing countries that have lost forward contracting capacity due to unaffordable margin costs of trying to manage the induced volatility of financial speculation. Position limits, based on comprehensive, accurate and simultaneous reporting of trade data for all market participants, and effectively enforced by an adequately resource CFTC, will enable a fair and transparent market for all participants, and reduce the extreme volatility in "commodity prices [that] act as a serious distortion on the development process."[ii] IATP greatly appreciates the opportunity to comment on what is perhaps the most complex and difficult set of rules to implement Title VII of the Dodd-Frank Act in commodity markets.

General Comment

Position limits may be defined as a predetermined maximum number of derivatives (futures, options and swaps) contracts reported to the CFTC that may be controlled by any one trader or group of traders at a certain point of time or over a given period of time. However, the position limit is not a magic number that by its mere setting prevents excessive speculation and market

manipulation. Rather, a position limit is a regulatory tool whose specific numerical expression for referenced commodity contracts is subordinated to the statutory objectives of the Commodity Exchange Act (CEA) Sec. 4a) as amended by the Dodd-Frank Act. IATP believes that the CFTC's proposal to establish position limits "in two phases, which could involve multiple final regulations or different implementation dates" (4752) can be improved by considering not simply the quantity of liquidity supplied by the position limits proposed but whether the trading practices that furnish this liquidity serve the statutory objectives.

Accordingly, IATP has evaluated the proposed regulations to determine whether they and their exemptions, can achieve the statutory objectives, given contemporary trading practices and market structure. Generally, we believe that the proposed regulations are more oriented towards preventing market manipulation by one trader than addressing the prevailing situation in which markets are distorted by the excessive speculation resulting from similar trading practices by several larger traders. (The question of whether the Congress will allocate sufficient budgetary resources to comply with what Dodd-Frank authorizes to implement and enforce position limits and other regulations, is, of course, not a matter for regulatory comment.[iii]) The objectives of position limits, as amended in Dodd-Frank, are:

- Diminish, eliminate or prevent excessive speculation as described under this section (4a);
- Deter and prevent market manipulation, squeezes, and corners;
- Ensure sufficient liquidity for bona fide hedgers; and
- To ensure that the price discovery function of the underlying market is not disrupted.

Our comments focus on the following aspects of proposed regulations that we hope will be of use to the Commission as it deliberates finalization of the regulations:

- Annual calculation of spot-month and conditional spot-month position limits, and the Designated Contract Market's calculation of the annual estimate of the deliverable supply of physical commodities for each of 28 referenced contracts as a basis for those limits;
- Phasing in non-spot month position limits, calculated as an open interest formula following reporting of unreported U.S. commodity swaps trading data, currently estimated to be about seven times the notional value of exchange reported data;
- The efficacy of the open interest (the total number of futures contracts that have not been fulfilled by delivery or that have not been liquidated) formula for preventing excessive speculation resulting from passive index trading practices and strategies;
- Legacy position limits: exempting enumerated agricultural commodities from the open interest based formula;
- Application of aggregate position limits to contracts executed on or regulated in Foreign Boards of Trade.

The CFTC, in consultation with relevant government agencies and affected industries, producers and consumers, should estimate deliverable supply and set spot-month and

conditional spot-month position limits based on those estimates, revising them if the limits fail to help manage extremely volatility.

The Commission's position limit methodology, in its first phase, relies on the accuracy of the estimated deliverable supply of the physical commodities in the referenced contracts, as determined by the Designated Contract Markets (DCMs). "Consistent with the Commission's long-standing policy regarding the appropriate level of spot month limits for physical delivery contracts, these position limits would be set at 25 percent of estimated deliverable supply. The spot month limits would be adjusted annually thereafter." (FR 4757) IATP is unable to do a quantitative analysis of referenced contracts to determine whether the application of this formula will prevent market manipulation, excessive speculation and disruption of price discovery for the commercial hedgers that take delivery of physical commodities. However, many bona fide hedgers in the CMOC believe this limit to be set far too high to comply with these statutory requirements. In light of their criticism of the proposed regulations and the current dominance of the market by swaps dealers and index speculators, IATP believes that the CFTC should reconsider how it both estimates deliverable supply and how it sets spot-month and conditional spot-month position limits based on those estimates.

Commodity market structure has changed sufficiently since the establishment of the Commission's "long standing policy" on spot-month limits so that the Commission, and not the DCMs, should estimate deliverable supply always, not just when DCM estimates are "inconsistent" (FR 4757). (The Commission recognizes this market structure change in regulation 151.4 by noting that the referenced contracts are not just futures contracts but "economically equivalent swaps" to the futures contracts. According to CFTC Chairman Gary Gensler, the Over the Count swaps market that the Commission will begin to regulate as a result of Dodd-Frank is currently about seven times the notional value of the regulated futures and options market.[iv]) If the Commission decides to delegate to the DCMs the authority to estimate deliverable supply, it should amend the proposed regulation to provide for emergency meetings to estimate deliverable supply if prices and/or supply becomes highly volatile. IATP believes representatives of commodity producers, consumers, processors, and transporters, as well as officials from relevant U.S. federal agencies should be consulted by the Commission both for estimating deliverable supply and for setting position limits based on that supply.

If the estimation is made only annually, despite inconsistency of DCM estimates that will exacerbate price volatility, the price discovery disruption and damage to bona fide hedgers will be done be by the time the Commission meets to correct the DCM estimate. It is worth noting that "lack of reliable and up-to-date information on crop supply and demand and export availability," has been identified internationally as a "root cause" of "unexpected price hikes and volatility." [v] Deliverable supply estimates are vulnerable to this same lack of reliable and up-to-date information.

The proposed "conditional spot-month limit" formula for referenced contracts that are cash-settled only and never result in the delivery of a physical commodity "is consistent with Commission guidance" and intended to diminish "the incentive to exert market power to manipulate the cash settlement price or index to advantage a trader's position in the cash-settlement contract" (FR 4758). The conditional spot-month limit suffers from the aforementioned vulnerability of the spot-month limits to inconsistency of DCM estimates of deliverable supply. Since the proposed conditional-spot month limit is five times the spot month limit, the conditional spot limit amplifies that vulnerability. Even if estimates of deliverable

supply prove to be reliable, the conditional spot-limit provides the trader of the cash settled index, e.g. an Exchange Traded Fund, with a mechanism for avoiding the spot-month limit to which bona fide hedgers will be subject. It is not clear to us why the proposed conditional spot-month limit is necessary to provide sufficient liquidity so that bona fide hedgers are able to manage commercial risk.

Non-spot month position limits: The open interest formula, applied as an interim measure to calculate non-spot month limits until more comprehensive trade data is reported for CFTC analysis, should not be the basis for calculating non-spot-month limits once the CFTC has sufficient and reliable swaps trade data to set non-spot month position limits in 2012.

Towards aggregating position limits for futures, options and swaps contracts, the Commission proposes a second phase of rulemaking in which non-spot-month position limits would be imposed only after currently unreported swaps trade data were reported in sufficient quantity and with sufficient reliability of accuracy that the Commission could confidently set non-spot month position limits. The proposed rule states that the Commission hopes to begin to collect "positional data" on physical commodity swaps by the third quarter of 2011. (FR 4756) As Commissioner Bart Chilton notes in his comments on the release of the proposed rule, there is no statutory basis for delaying the Dodd-Frank mandated position limit deadlines (Appendix 3, FR 4777). And, as he notes, "We have more speculative positions in the commodities markets than ever before." This statement is confirmed by CFTC compiled data on notional long only positions in commodity index funds, which already in September 2010 were approaching position levels at the height of the commodity price bubble of June 2008.[vi] Since then long only positions have further increased, meaning that the 'long only' bets on commodity prices to increase are important price drivers regardless of market fundamentals because index investors bet on the index formula, not on the fundamentals of each indexed contract.

Caught between the rock of the Dodd-Frank deadlines and the hard place of present market conditions, Chairman Gensler has instructed staff to collect more detailed information about large trader positions in excess of the proposed open interest formula for position limits in the 28 contracts (19 of which are agricultural) for which limits are proposed. (Appendix 2, FR 4777) This collected information will be reviewed under existing legislative authority, but not necessarily trigger any regulatory action against excessive speculation or market manipulation. The trigger for collecting information from the 140 entities that the Commission believes will be affected by this interim measure for the non-spot-month position limit rule is that of the open interest formula, i.e. 10 percent of the first 25,000 contracts of open interest in a referenced commodity and 2.5 percent of all contracts thereafter. The Commission believes that the application and enforcement of this formula would "help prevent a speculative trader from acquiring excessively large positions and thereby would help prevent excessive speculation and deter and prevent market manipulation" (FR 4759) This formula is also intended to result in position limits high enough "to ensure sufficient liquidity for bona fide hedgers and avoid disrupting the price discovery process given the limited information the Commission has with respect to the size of the physical commodity swaps market" (FR 4759).

It is true that Commission does not have complete trade data of open interest because of the exemption of swaps dealers (e.g. the "Enron Loophole") from reporting their trades for referenced contracts daily to the CFTC, as is required of exchanges. Using the open interest formula as a trigger for collecting large trader information may be an interim solution until non-spot limits are agreed. However, it does not follow that the Commission must rely on an

open interest formula for position limit calculations that had been developed for much smaller agricultural markets and prior to the transformation of commodity markets from dominance by commercial hedgers to the present dominance by index speculators.[vii]

The dominance of index speculators, according to 2003-2008 CFTC data in referenced commodities, e.g. as analyzed in a seminal study by Masters and White,[viii] should cause the Commission to reconsider whether a pre-transformation open interest formula will be adequate to achieving the CEA 4a) objectives, as amended by Dodd-Frank. Masters' and White's sources estimated that in early 2008 about 60 percent of all commodity index funds were controlled by four index swaps dealers, Goldman Sachs, J.P. Morgan, Morgan Stanley and Barclay's Bank. Index funds comprised about 40 percent of all open contracts bet to increase prices.[ix] Four firms invested 24 percent of all commodity market liquidity not in response to the hedging needs of commercial risk, but to increase the price of the indexed contracts regardless of fundamentals. Since index investors do not invest in commodity markets to hedge commercially, why should index investors and commercial hedgers be subject to the same position limit formula? IATP agrees with the Air Transport Association of America Inc. (ATA) that the CFTC can and should calculate separate and lower non-spot-month positions limits for index speculators in order to prevent excessive speculation and disruption or price discovery.[x] Commercial hedgers in all the referenced commodities do not need the surfeit of liquidity that the higher limits would encourage. We also believe that ATA is right to doubt that an open interest formula, elaborated in 1992 to calculate non-spot month limits for much smaller agricultural markets, is relevant to calculating such limits for today's much larger and more interconnected commodity markets.

Legacy position limits for referenced agricultural contracts: the CFTC is right to not increase these position levels for use in the open interest formula, which makes no distinction between liquidity for commercial hedging and liquidity for purely financial speculation.

The Commission asks whether the current single-month spot limits for enumerated agricultural contracts (legacy limits) should be increased "as an exception to the general open interest based formula." IATP does not believe that the open interest based formula distinguishes between liquidity used for commercial hedging and liquidity that is purely speculative, i.e. invested without regard to fundamentals and without a commercial hedging purpose. Therefore, we do not agree that single month position levels should be raised, as proposed to the Commission by the Chicago Board of Trade. Nor do we agree that the position limits on wheat for contracts at the Minneapolis Grain Exchange and the Kansas City Board of Trade should be raised. The argument for raising the agricultural contract limits to reflect 2010 open interest levels[xi] ignores evidence that the lower, 2004 open interest based legacy limits were not enforced to prevent excessive speculation and distortion of price discovery.[xii] That said, the spot-month position limits for enumerated agricultural commodities will likely require more than annual revision due to the effects of climate change on the estimated deliverable supply for each referenced contract upon which spot-month position limits will be based.

The CFTC is right to include trades by U.S. registered firms, but executed on and subject to regulations of Foreign Boards of Trade, in CFTC calculations of aggregate position limits, subject to the two CFTC stipulated caveats.

Recognizing the imperative of international regulatory cooperation for commodity markets to work effectively and fairly, IATP has submitted comments to the European Commission's rulemaking process, most recently a February 2, 2011 comment on a consultation paper for the revision of its Markets in Financial Instruments Directive (MiFID).[xiii] We have been greatly heartened by the Commission's emphasis on international regulatory cooperation and harmonization, most recently expressed in a March 22 speech by Chairman Gensler to the European Parliament committee responsible for amending MiFID.[xiv] There is, however, a well-coordinated and extremely well-financed lobbying campaign in Washington and Brussels to threaten moving financial industry operations and/or "migrate" trade elsewhere, if the financial services industry perceives regulation to be too stringent. For example, Goldman Sachs chief executive officer Lloyd Blankfein is reported to have said in Brussels, "Operations can be moved globally and capital can be access globally."[xv] As the Financial Times recently reported, "US banks are urging regulators writing new rules on the derivatives markets to keep their hands off the banks' swap businesses in London and other overseas financial centres."[xvi] It almost goes without saying that this lobbying campaign has extended to requesting the exclusion of U.S. registered firm's trades executed on Foreign Boards of Trade from accounting in their CFTC regulated aggregate position limits.

Congruent with this recognition of the imperative of international regulatory cooperation and harmonization for commodity markets, IATP believes that traders' positions executed on Foreign Boards of Trade or subject to FBOT regulation must be accounted in the calculation of the U.S. registered trader's aggregate position limits for each of the referenced contracts, subject to the two caveats stipulated by the Commission. (FR 4763) U.S. exchanges (and soon to be organized Swaps Execution Facilities) have agreements with many FBOTs to clear and execute each other contracts. To exclude FBOT contracts from the aggregate position limits of U.S. registered traders would undermine the international regulatory cooperation needed to make this cross-platform clearing and execution part of a fair and transparent global market. Excluding U.S. trades on FBOTs from aggregate position limits could result in the exclusion of U.S. registered traders from the electronic trading and order matching system of the FBOTs, if foreign regulators require the inclusion of FBOT executed and cleared contracts in their aggregate position limits and the CFTC does not.

Conclusion

IATP recognizes the significant challenges confronting the CFTC in the implementation of these and other proposed regulations, carried out in a very difficult budgetary, political and market environment. We appreciate the thoughtful analysis developed by CFTC staff and Commissioners, and the extensive information available from webcast consultations and the CFTC website. IATP is grateful for the CFTC's careful review of these comments and would be pleased to answer any questions that staff reviewers may have about them. We look forward to working further with CFTC on Dodd-Frank implementation, particularly as regard

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[i]E.g., Gregory Meyer, "High-speed commodity traders under crash scrutiny," *Financial Times*, March 10, 2011.

[ii] "Recent developments in key commodity markets: trends and challenges," UNCTAD secretariat, January 12, 2010, at 11. http://www.unctad.org/en/docs/cimem2d7_en.pdf

[iii] Ben Protess, "Regulators Decry Proposed Budget Cuts in C.F.T.C. budget," *The New York Times*, February 24, 2011. http://dealbook.nytimes.com/2011/02/24/regulators-decry-proposed-c-f-t-c-budget-cuts/?ref=todayspaper

[iv] Chairman Gary Gensler, "Testimony before the U.S. House of Representatives Committee on Appropriations," Commodity Futures Trading Commission, March 17, 2011. http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-74.html

[v] "Final Report," Extraordinary Joint Intersessional Meeting of the Intergovernmental Group (IGG) on Grains and the Intergovernmental Group on Rice," Committee on Commodity Problems, United Nations Food and Agricultural Organization, September 24, 2010. http://www.tradeobservatory.org/library.cfm?refID=107774

[vi] Parantap Basu and William J. Gavin, "What Explains the Growth in Commodity Derivatives?" *Federal Reserve Bank of St. Louis Review*, January-February 2011, Figure 1 B. http://research.stlouisfed.org/publications/review/11/01/37-48Basu.pdf

[vii] See Revision of Federal Speculative Position Limits, Federal Register, 12766, 12770 (April 13, 1992), cited in forthcoming comments from the Air Transport Association Inc.

[viii] Michael Masters and Adam White, "How Institutional Investors are Driving Up Food and Energy Prices," The Accidental Hunt Brothers, July 31, 2008, Table 3 at 16 and Table 7 at 19. http://accidentalhuntbrothers.com/?cat=4

[ix] Ibid. at 23.

[x] See the American Transport Association's forthcoming comments for the proposed position rule.

[xi] E.g. Roberta Rampton, "Gresham: CFTC limits unfairly 'insulate' ag markets," Reuters, February 16, 2011.

[xii] E.g. "Excessive Speculation in the Wheat Market," Permanent Subcommittee on Investigations, U.S. Senate, June 24, 2009 http://levin.senate.gov/newsroom/supporting/2009/PSI.WheatSpeculation.062409.pdf

[xiii] http://www.tradeobservatory.org/library.cfm?refID=107917

[xiv] http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-75.html

[xv] Patrick Jenkins and Megan Murphy, "Goldman in Europe warning," *Financial Times*, September 30, 2010.

[xvi] Gregory Meyer and Aline van Duyn, "US banks' plea on swap rules," *Financial Times*, March 17, 2011.