215 Pennsylvania Avenue, SE • Washington, D.C. 20003 • 202/546-4996 • www.citizen.org

February 7, 2014

Melissa Jurgens
Secretary Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.
Washington DC 20581

Re: RIN 3038–AD99; Position Limits For Derivatives

Dear Ms. Jurgens:

Public Citizen hereby submits comment on the Notice of Proposed Rulemaking, "Position Limits for Derivatives," issued by the Commodity Futures Trading Commission ("CFTC" or "Commission") pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[1]

Public Citizen is a national consumer advocacy organization with over 300,000 members and supporters, representing the interests of working families.[2] The director of Public Citizen's Energy Program, Tyson Slocum, serves on the CFTCs Energy and Environmental Markets Advisory Committee.

In general, while we applaud the Commission's continued intransient endorsement of position limits, the levels set by the CFTC remain too high, allowing traders wide latitude to unduly influence markets and engage in excessive speculation. In addition, the Commission's proposal to revisit the setting of the limits once every two years is too infrequent; rather, it should be reviewed once annually.

I. Background

On July 21, 2010, President Barack Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act into law. On that occasion, he declared that the reforms passed Congress despite "the furious lobbying of an array of powerful interest groups… [the legislation will] rein in the abuse and excess that nearly brought down our financial system. It will finally bring transparency to the kinds of complex and risky transactions that helped trigger the financial crisis…***for these new rules to be effective, regulators will have to be vigilant***…in the end, our financial system only works—our market is only free—when there are clear rules and basic safeguards that prevent abuse, that check

[1] www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2013-27200a.pdf
[2] citizen.org

215 Pennsylvania Avenue, SE • Washington, D.C. 20003 • 202/546-4996 • www.citizen.org

excess…and that's what these reforms are designed to achieve—no more, no less. Because that's how we will ensure that our economy works for consumers"[3] [emphasis added].

Public Citizen and AFR first submitted comments to the Commission's original Dodd-Frank Position Limits rulemaking, adopted on October 18, 2011.[4] Upon a legal challenge by trade associations financed by Wall Street banks and other financial institutions, Judge Robert Wilkins of the U.S. District Court for the District of Columbia vacated the Commission's rule on September 28, 2012, ruling that the Commission failed to demonstrate that the position limits were necessary. This current rulemaking responds to that court decision, and the Commission clearly presents a strong case that position limits are needed and necessary.

Congress passed the Dodd-Frank Act, including mandatory position limits, with the understanding that unregulated derivatives play a significant role in encouraging excessive speculation on the part of Wall Street banks. Such speculation increases prices paid by households for staple goods such as food and gasoline, and also increases systemic risks to the financial system.

A central tool Congress and President designed to address excessive speculation was the order to the CFTC to enact firm <u>position limits</u> aggregated across markets for all swaps. Section 737 of Dodd-Frank orders that the CFTC "<u>shall</u> by rule, regulation, or order establish limits on the amount of positions, as appropriate, other than bona fide hedge positions, that may be held by any person with respect to contracts of sale for future delivery or with respect to options on the contracts or commodities traded on or subject to the rules of a designated contract market…[in order] to diminish, eliminate, or prevent excessive speculation…[and] to deter and prevent market manipulation, squeezes, and corners."

The Commission is required to establish position limits as Congress intentionally used the word, "shall," to impose the mandatory obligation. Congress made the express decision to change the permissive language in an earlier version of the Wall Street Reform and Consumer Protection Act to a mandate. When the House version of the bill was introduced on December 2, 2009, Section 3113 on Position Limits stated: "The Commission may, by rule or regulation, establish limits (including related hedge exemption provisions) on the aggregate number or amount of positions in contracts based upon the same underlying commodity (as defined by the Commission) that may be held

[3] www.whitehouse.gov/the-press-office/remarks-president-signing-dodd-frank-wall-street-reform-and-consumer-protection-act
[4] www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-28809-1a.pdf

by any person, including any group or class of traders [.]" However, before the Act passed the House, the word "may" was replaced by "shall" pursuant to an amendment proposed by former House Agriculture Committee Chairman Collin Peterson. This amendment was incorporated into the bill, survived the conference negotiations, and was eventually enacted into law.

Not only did Congress mandate position limits, it specified the goals such position limits were to fulfill. Section 4a (a) (3) of the Commodities and Exchange Act states that position limits shall serve to:

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

Note that this statement explicitly lists the prevention of excessive speculation as a separate goal from the deterrence of direct market manipulation such as squeezes and corners, indicating that Congress intended position limits to reduce the overall role of speculation in the market.

II. Excessive Speculation and Commodities Prices

Excessive speculation has been a key driver of recent commodity price increases. An example is given by recent events in the oil market, which has experienced record swings in prices. Leading into the run-up of oil prices in 2007-08, the share of market participants who were speculators as opposed to commercial end users increased from 20 percent in the early part of the decade to a peak of 55 percent in 2008.[5] World oil futures trading volume increased from 4.5 times world oil demand in 2002 to 14.7 times world oil demand in 2008.[6] This period saw steadily increasing oil prices, growing from under $40 a barrel in early 2003 to $92 a barrel in January, 2008, followed by an unprecedented speculative price run-up of 50 percent in the first six months of 2008. Reaching a peak of over $140 in early July 2008, prices collapsed to under $40 in December, 2008. Prices

[5] *Who is in the Oil Futures Market & How Has it Changed?,* James A. Baker III Institute for Public Policy, Rice University, August 2009.

[6] Khan, Mohsin, The 2008 Oil Price 'Bubble' , Peterson Institute on International Economics, Policy Brief, August 2009.

PUBLIC CITIZEN
215 Pennsylvania Avenue, SE • Washington, D.C. 20003 • 202/546-4996 • www.citizen.org

began to rise again with the economic recovery in May, 2009, and now hover around $95/barrel.[7] Banks, hedge funds and others have once again increased their positions in energy markets to record levels (by 64% at one point) which may well help to explain the recent run-up in crude oil prices far beyond the supply demand fundamentals.[8]

Of course, there were many significant economic events over this period, and a role for fundamentals in explaining changes in oil prices. Nevertheless, fundamentals change slowly while these wild short-term price gyrations bear all the marks of a bubble driven by financial speculation. Similar trends can be seen in other key commodity markets, such as world grain markets. This market also showed a pattern of explosive growth in speculative futures positions accompanied by wild swings in prices (including record price highs which threatened food security for hundreds of millions of people).[9] These and similar market trends constitute a prima facie case for a large role of speculation in impacting commodities prices.

Academic studies have raised questions about the connection between speculation and commodities prices.[10] Many others have found evidence supporting the connection.[11] Academic debate is healthy and part of our tradition of open examination. The differences between various academic studies are often due to simplifying assumptions embedded in various economic models (such as perfect information, or a single representative agent driving prices in commodity markets) or to differences in assumptions used in statistical modeling of time series data on prices.[12] New work using less restrictive (non-parametric) modeling assumptions is still emerging and showing the

[7] Oil price data from the Energy Information Administration, at the U.S. Department of Energy.

[8] Silla Brush, *Energy Speculation at Highest Levels on Record, CFTC's Bart Chilton Says*, March 15, 2011

[9] Robles, Miguel et. al, *When Speculation Matters*, International Food Policy Research Institute, IFPRI Issue Brief 57, February 2009.

[10] E.g. Irwin, Scott H., D.R. Sanders, R.P. Merrin. "Devil or Angel? The Role of Speculation in the Recent Commodity Price Boom (and Bust)." Journal of Agricultural and Applied Economics, 41(2009), pp. 393-402.

[11] Khan *supra* note 6; Robles *supra* note 9; Singleton, Kenneth, "*The 2008 Boom-Bust In Oil Prices*", Stanford University Graduate School of Business, May 17, 2010; Tang, Ke, W. Xiong. "*Index Investing and the Financialization of Commodities*." Working Paper, Department of Economics, Princeton University, 2010.

[12] See Singleton, Kenneth, "*The 2008 Boom-Bust In Oil Prices*", Stanford University Graduate School of Business, May 17, 2010, for an thorough discussion of modeling differences and how they affect conclusions in academic research on this topic.

extent to which modeling assumptions drive conclusions in this area.[13] Even though disagreement remains about the exact role and level of speculation in driving commodities prices, the leading experts in the field of e.g. energy prices concur that a real and significant role was played by speculation.[14]

Unfortunately, some commentators have attempted to misrepresent this academic controversy by claiming that there is some sort of academic consensus that financial speculation has not affected commodities prices. We read the weight of the academic evidence here as cutting in the opposite direction, that a consensus is emerging that financial speculation has played an important role in the increase in the volatility and the price peaks of commodities. However, the existence of some academic debate here is irrelevant. In the real world, financial speculation and price volatility have risen together on multiple vital commodity markets, and Congress has reacted to this evidence by a clear statutory directive to impose position limits and restrain speculation. In light of the human and economic risks of further dramatic spikes in commodity prices, this prophylactic measure is very rational. While support from academic economists is hardly necessary to justify it, we have also cited numerous academic studies by respected scholars that use sensible assumptions to demonstrate a strong link between commodity prices and financial speculation.

III. The position limits proposed by the Commission do not go far enough to have a meaningful impact on excessive speculation.

Proposed §150.2 would impose position limits for physical delivery contracts. CFTC would enforce spot-month limits by setting position limits at 25 percent of estimated deliverable supply. During the second phase, the CFTC would impose position limits for non-spot-month contracts based on open interest on a particular referenced contract. Under a formula proposed by the Commission, non-spot-month position limits will be set for each referenced contract at 10 percent of open interest in that contract up to the first 25,000 contracts, and 2.5 percent thereafter.

The justification for the proposed spot-month position limits is to minimize the potential for corners and squeezes by facilitating the orderly liquidation of positions. While preventing market manipulation, including corners and squeezes is an important goal,

---

[13] Boos, Jaap and Maarten Van Der Molen, *A Bitter Brew? How Index Fund Speculation can Drive up Commodity Prices* , Seminar Paper, University of Ghent, February 2nd, 2011.

[14] Hamilton, James, *The Causes and Consequences of the Oil Shock of 2007-2008*, Brookings Papers on Economic Activity, 2009; Parsons, John, *Black Gold and Fools Gold: Speculation in the Oil Futures Market*, Economia, Vol. 10, No. 2, pp. 81-116, 2010.

different position limits are necessary to prevent excessive speculation. As noted above, the prevention of market manipulation, the prevention of excessive speculation, and the preservation of the price discovery function of markets are all cited as wholly separate goals of the imposition of position limits in the Dodd-Frank Act. This is because market manipulation can occur only when a large position is concentrated in the hands of a single actor who controls a large share of the physical commodity to be delivered. However, excessive speculation and interference with price discovery can occur when many speculators together create a large purely speculative financial stake in the market. Even when no one speculator attempts deliberate manipulation to raise prices, this increase in the speculative stake in the market can lead to increased volatility, hoarding, and a delinking of commodities prices from the fundamentals of physical supply and demand. It is this general increase in speculation that is discussed in the academic studies cited in Part II above.

To satisfy the wholly separate statutorily mandated goal of preventing excessive speculation, the Commission must therefore reconsider whether the proposed levels are sufficient to prevent "excessive speculation" in the marketplace as a whole. Setting limits that only constrain the positions held by a single market actor, without any overall limit on the overall speculative investment in the market, risks a situation where total speculative investment in the market remains the same or even grows but is simply split between a greater number of investors. Experts in commodities markets have made exactly this point:[15]

> "Gregory Mocek, a former enforcement director at the CFTC, said it is possible that imposing position limits could spur smaller firms without cutting back on the volume of activity in markets. 'You could see a lot more smaller operations depending upon how the rule plays out, and I'm not quite sure that's going to be in the best interest of the Commission….If the purpose of position limits is to cut back on excessive speculation, then it's possible that may not achieve their goal.'"

A direct limitation on overall speculation would be the most straightforward way to truly restrain excessive speculation. Once total speculative positions reached a level appropriate to provide market liquidity to bona fide commercial hedgers, speculators could be restricted from further investments. This could be done through tying the overall non-spot month position limits to an acceptable aggregate (market-wide) level of speculation, and tying individual trader limits to that aggregate level. In this way, individual trader limits would total to a reasonable overall limit. The Commission's

[15] Ayesha Rascoe, *CFTC Limits Plan Could give Rise to Smaller Firms*, Commodities Now, February 11, 2011.

215 Pennsylvania Avenue, SE • Washington, D.C. 20003 • 202/546-4996 • www.citizen.org

current proposal to tie non-spot month limits to total open interests in the market appears to simply accept the current level of speculation as acceptable instead of reducing it.

In addition we are concerned by the Commission's proposal, in §150.3(c), to incorporate "a conditional spot-month limit that permits traders without a hedge exemption to acquire position levels that are five times the spot-month limit if such positions are exclusively cash-settled contracts and the trader holds physical commodity positions that are less than or equal to 25 percent of the estimated deliverable supply." This appears to be intended to allow certain financial institutions and speculators to continue doing business as usual. Congress, in allowing an exemption for bona fide hedgers but not pure speculators, could not possibly have intended for the Commission to implement position limits that allow market speculators to hold 125 percent of the estimated deliverable supply. Once again, while this exception for cash-settled contracts would avoid market manipulations such as corners and squeezes (since cash-settled contracts give no direct control over a commodity), it does not address the problem of undue speculative influence on futures prices.

In addition, § 150.2(e) (3) proposes that the CFTC will revisit its proposed spot month position limit setting every two years. Given the dynamic changes that often define commodity markets and the key players within these markets, Public Citizen believes that the CFTC must review the setting of position limits on an annual basis, rather than once every two years as proposed.

Households and the American economy cannot continue to afford to be subjected to the excessive speculation in energy markets. The CFTC must follow the congressional intent and establish firm position limits that will limit the influence of speculative capital on commodity prices while continuing to allow legitimate commercial users of swaps markets access to fairly priced hedges.

We appreciate the opportunity to comment on the proposed rule. If you have any questions, please contact Tyson Slocum at tslocum@citizen.org and (202) 454-5191.

Sincerely,

Tyson Slocum
Director of Public Citizen's Energy Program