



February 10, 2014

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

Re: Position Limits for Derivatives
(CFTC RIN 3038-AD99)

Dear Ms. Jurgens:

Better Markets, Inc.¹ appreciates the opportunity to comment on the above-captioned Proposed Rule (the “Proposed Rule”) published by the Commodity Futures Trading Commission (“CFTC”, “Commission”) on December 12, 2013, the purpose of which is to establish position limits for certain physical commodity derivatives, as required by and pursuant to provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“the Dodd-Frank Act”).²

INTRODUCTION

Physical commodity producers and purchasers grow the food we eat, generate the power in our homes, manufacture the vehicles we travel in, produce the fuel we need, and otherwise directly enable not just modern life, but also a rising standard of living. It is not an overstatement to say that commodity markets are essential for every man, woman, child, and business in the United States. That is what is at stake when regulating these markets and why it is vital to regulate them properly.

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- ¹ Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.
 - ² While this letter responds specifically to the Proposed Rule, it builds upon the information contained in the following comment letters filed by Better Markets, which are incorporated hereby as if fully set forth herein. See Better Markets Comment Letter, “Position Limits for Derivatives,” (Mar. 28, 2011), *available at* [http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=34010&SearchText=better%20markets \(“March 28, 2011 Letter”\)](http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=34010&SearchText=better%20markets%20(March%2028%202011%20Letter)); Better Markets Comment Letter, “Position Limits for Futures and Swaps,” (Jan. 17, 2012), *available at* <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=50076&SearchText=Better%20Market>; *and* Better Markets Comment Letter, “Aggregation, Position Limits for Futures and Swaps,” (Jun. 29, 2012), *available at* <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=58292&SearchText=better%20markets>.

Over the past two decades, commodity markets have experienced a sea change in both market structure and deregulation. As the culmination of a series of deregulatory measures that had already significantly eroded position limits and other traditional market protections, the heavily criticized 2001 Commodity Futures Modernization Act opened a Pandora's Box of deregulated derivatives trading. Since then, an incredible number of market crises have occurred in a short period of time. The Amaranth Natural gas episode in 2001, the unprecedented speculative volatility of oil prices during 2008, and numerous other market events have illustrated the need for a new and effective regulatory structure in commodities derivatives.

Thus today's commodity derivatives markets require immediate intervention. Current market symptoms, including sustained and unprecedented volatility, decreased commercial utility, and physical price disconnection have been occurring on a routine basis and have generated immense and unnecessary costs to businesses and households. There is a clear need for swift and comprehensive regulation.

The popular debate over the role of speculation in commodity markets, and the role of regulators in containing it, has existed for nearly 100 years,³ and the congressional mandate to act in prevention of excessive speculation has existed for nearly as long. While the scope and degree of enforcement has varied significantly over the years, regulators have repeatedly seen fit to limit speculative positions in response to nearly every market crisis since the 1920's. Now, in the midst of the largest sustained disruption to commodity markets in their volatile history, speculative position limits have never been more essential.

The Proposed Rule indicates the Commission's acknowledgement of the urgent call to action, but falls short of accomplishing its intended goal of restoring and protecting the functional market utility to physical commodity producers and consumers. The comments below will demonstrate the need for an effective position limits regime and propose changes to the Proposed Rule to accomplish that.

First, we provide an overview of speculation in commodity markets, address some of the structural changes that have occurred in the futures market in recent years, and discuss the ways in which the futures market impacts the physical market it is meant to serve. We go on to shine a spotlight on the overwhelming force of unlimited speculation by Commodity Index Funds. Finally, we comment on the Proposed Rule, and outline the fundamental changes required to ensure the rule accomplishes its statutory purpose.

While this comment letter will cover the substantive issues identified above, we remind the Commission that substantial treatment of these and other related topics is contained in previous comment letters submitted by Better Markets, which are identified

³ On the discourse leading up to the 1936 CEA: "Like the debates throughout the 1920s, opinions sharply differed as to whether regulation could better be accomplished by the exchanges rather than by a federal agency,²² whether speculators were to blame for depressing grain prices, and whether the imposition of limits on speculation would impair the ability of grain merchants and others in the grain business to hedge." See Testimony of Dan M. Berkovitz "Position Limits and the Hedge Exemption, Brief Legislative History" (Jul. 28, 2009), available at http://www.cftc.gov/PressRoom/SpeechesTestimony/berkovitzstatement072809#P19_5690.

below and which are incorporated as if fully set forth herein.⁴ In addition, various other public interest groups, academics, commodity producers, and end-users have provided much thoughtful input on an array of issues arising from and related to the Proposed Rule, which are also identified below and which are incorporated as if fully set forth herein.⁵

The Commission must ensure that the final rule carefully considers and reflects all comments submitted, including in particular the concerns and suggestions provided by the commercial hedgers that rely on these markets to conduct business every day. These are, after all, precisely the interests that Congress deputized the CFTC to protect with this Rule.

All too often, the interests of the consumer, small-businesses, and the public are subordinated to those of the largest financial players and their affiliates. Financial industry lobbyists have found great success in persuading regulators that any regulation that affects their profits will somehow bring some grave amorphous harm to the markets due to some theoretical reduction in liquidity. As it has for a hundred years, the threat of evaporating liquidity has been made loudly in connection with the Proposed Rule. Almost never mentioned is the financial players' real fear: evaporating profits from markets that actually serve commercial producers and consumers rather than trading houses.

We urge the Commission to consider carefully, and give the appropriate significant weight to, the liquidity concerns raised by actual and real industry participants. While liquidity provided by speculators is a factor when considering any structural or regulatory changes, baseless threats of its evaporation cannot serve to impede responsible oversight and comprehensive regulation. Moreover, the very real threat and danger from a market with so much speculative liquidity that it drowns out the commercial utility of a given market must be fully considered and included within any responsible regulatory regime.⁶

In fact, while economists (especially those linked with the financial services industry) often point out that too little speculative liquidity can hurt market functioning, what is clear is

⁴ See Better Markets Comment Letter, "Position Limits for Derivatives," (Mar. 28, 2011), *available at* <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=34010&SearchText=better%20markets> ("March 28, 2011 Letter"); Better Markets Comment Letter, "Position Limits for Futures and Swaps," (Jan. 17, 2012), *available at* <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=50076&SearchText=Better%20Market>; *and* Better Markets Comment Letter, "Aggregation, Position Limits for Futures and Swaps," (Jun. 29, 2012), *available at* <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=58292&SearchText=better%20markets>.

⁵ See ATA Comment Letter (Apr. 23, 2010), *available at* <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=17197&SearchText>; Delta Airlines Comment Letter (Mar. 28, 2011), *available at* <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=33989>; Americans for Financial Reform Comment Letter (Mar. 28, 2011), *available at* <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=34046>; University of Maryland School of Law Comment Letter (Mar. 28, 2011), *available at* <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=33850>; *and* Commodity Markets Oversight Coalition Comment Letter (Aug. 31, 2011), *available at* <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=48123>.

⁶ Please see Section 3. The Role of Speculation and Recent Market Structure Changes for discussion of this concept below.

that the opposite case is also true. Too much speculative liquidity can create speculative boom and bust situations, harming not only market participants, but many innocent bystanders as well. This situation is perhaps even more harmful to society than the former, and is the crucial reason why speculative position limits to deter “excessive speculation” were enshrined in Title VII of the Dodd-Frank law, which itself was drafted in the aftermath of a previous dangerous and damaging speculative boom and bust.

Unfortunately, the Proposed Rule has crafted position limits that are so high, and so narrowly applied, that they fail to meaningfully prevent or reduce excessive speculation outside of the most egregious cases of manipulation. They also fail to target particularly harmful types of speculation such as Commodity Index Trading, despite the fact that Congress clearly empowered the Commission to place additional limits on any “group or class of traders.” Importantly, lower limits and specific limits for Commodity Index Traders (“CITs”) are necessary to prevent excessive speculation. Unfortunately, the core functions of the commercial markets will not be adequately served by this Rule as currently drafted.

1. Framing Modern Commodity Markets

Theoretically, physical commodity markets, by their nature, are the exclusive domain of producers and consumers of tangible products. They are unique markets in this capacity, as the primary participants are almost exclusively one-way actors: producers sell their product, and consumers buy it. In practice, there is scant reason for either participant to transact on the other side of the physical market. This presents an obvious limitation to the ability of producers and consumers to optimally transact within the physical market – the demand of consumers and the supply of producers need not, and often do not, coincide efficiently to transact.

It is easy to understand, then, the longstanding need for a robust commodity futures market, which matches a broader base of producers and consumers than would otherwise be the case, and facilitates the intermediation of a small number of short-term speculators (“traditional speculators”) who are willing to trade on both sides of the market to profit from cases where buyers and sellers are not well-matched. This allows commercial handlers to manage risk in a manner unconstrained by crop seasons or production schedules. In addition to facilitating hedging, the derivatives markets can provide a valuable source of market information, both directly from price and volume data, and indirectly from the expectations and sentiment they reflect.

The commercial benefit of derivatives markets stems from the balance of its ecosystem: producers, consumers, and two-way traditional speculators, all in appropriate proportions. Thus the service of speculators is important to the smooth function of the commercial market. It **provides a liquidity buffer supplied by a minority of two-way market participants with goals uncorrelated to those of commercial hedgers**. However, allowing outsiders with no commercial stake into this important marketplace **also carries a critical risk**.

Speculators have a demonstrable history of causing enormous disruption when amassing sufficient **market proportion** (when speculation as a whole is too great a percentage of the market), **market concentration** (when one trader or a small group control

too much of the market), or **manipulative intent** (when a trader or group seeks deliberately to distort prices for private profit). The risk posed by speculators must be vigilantly monitored and managed, or the benefits of the liquidity buffer will not outweigh its costs—costs ultimately born by businesses and individuals on Main Streets across the globe when speculative boom and bust cycles are created.

Speculation in Derivatives Markets pre-2000

In recognition of the indispensable service provided by physical commodity producers and consumers, regulators have sought to preserve the ability to efficiently hedge price risks with commodity futures through the imposition of modest position limits on speculative positions for nearly a century.⁷ The central goal of these limits, like those currently proposed, is to limit speculation to the level at which it provides maximum benefit to commercial hedgers with minimal risk of market disruption.

This long history provides ample market evidence to inform modern regulators as they design an appropriate regulatory regime. Broadly, speculators in commodity futures historically constituted between 15%-30% of market activity, and within this range speculators productively facilitated effective hedging without meaningfully disrupting or independently shaping the market's behavior.⁸

Intuitively, this makes sense. The beneficial role of speculators is to intermediate between producers and consumers of physical commodities as they hedge, but only when other commercial market participants do not naturally do so themselves. One might imagine a perfectly disjointed market, whereby producers and consumers never match to efficiently transact with each other. In such a market, the optimal level of speculation would approach 50%, since every transaction would require an intermediate trade by a speculator to eventually match producers and consumers. In practice, of course, producers and consumers do naturally match up some percentage of the time without the requirement of an intermediating speculator, bringing the required percentage of speculation in a market to somewhere significantly below 50%.

Both common sense and market practice have demonstrated that when speculators (who are not commercially chained to underlying fundamentals) constitute a minority of the market, they can contribute to market efficiency⁹. To the extent that hedging (and the

⁷ “The first exercise of Federal authority to limit trading in the commodity futures markets occurred when the Congress enacted emergency legislation to stabilize the U.S. grain markets during the First World War. Under the Food Control Act of 1917 the trading in wheat futures was suspended and the U.S. Food Administration “secur[ed] a voluntary limitation” of 500,000 bushels on the trading of futures contracts for corn. After the war, Herbert Hoover, the wartime director of the U.S. Food Administration, testified that the limits on the trading of corn futures were “well carried out and during that period there was no manipulation of the market and no substantial interference with the normal processes of the hedging market.” See Testimony of Dan M. Berkovitz “Position Limits and the Hedge Exemption, Brief Legislative History” (Jul. 28, 2009), available at http://www.cftc.gov/PressRoom/SpeechesTestimony/berkovitzstatement072809#P19_5690.

⁸ See e.g. Working (1960), Peck (1981).

⁹ In response to measures to regulate speculation in grain markets after World War I, Herbert Hoover testified before the U.S. Food Administration in 1921, “my own inclination is to believe that as long as those speculative transactions are in comparatively small quantities they neutralize each other; it is only when a

fundamental supply and demand that compels it) dominates a market, the market tends to behave in a fairly predictable manner and tends to trade based on larger supply and demand forces.

Conversely, when speculative trading predominates in a market, the majority of trading decisions are based on the expectation of price action derived from the speculative decisions of others. This is fundamentally at odds with the purported goal of the futures market, which is to serve commercial hedgers whose risks reflect not the whims of professional speculators, but the supply and demand of physical products. In some cases, a full-fledged speculative boom can occur, followed by its corollary, a speculative bust. Ultimately this excessive volatility hurts commercial end-users (and the consumers who purchase their products) trying to respond to market signals that are due to excessive speculation, not supply and demand forces. **The goal of regulators involved in commodities derivatives markets should be to facilitate commercial trade, not to promote some alternate gambling venue.**

Speculation in Derivatives Markets Following De-Regulation

Following nearly thirty years of reasonably orderly commodities markets, a decade of deregulation swept through the financial and commodity markets in the 1990's. Many of the historical market safeguards were repealed or no longer enforced in favor of an unregulated market structure. Ultimately, these *ad hoc* deregulatory measures were formalized into a sweeping market deregulation overhaul codified into the Commodity Futures Modernization Act ("CFMA") of 2000.

Then, in the newly relaxed regulatory environment of the early 2000's, the level of speculation in certain commodity markets exploded. Here are just a few examples:

- From 1995-1999, 73% of CBOT Corn contracts were traded by commercial hedgers, while 36% are non-commercial today.
- From 1995-1999, 65% CBOT Wheat contracts were traded by commercial hedgers, whereas 8 out of every 10 contracts are speculative today.¹⁰

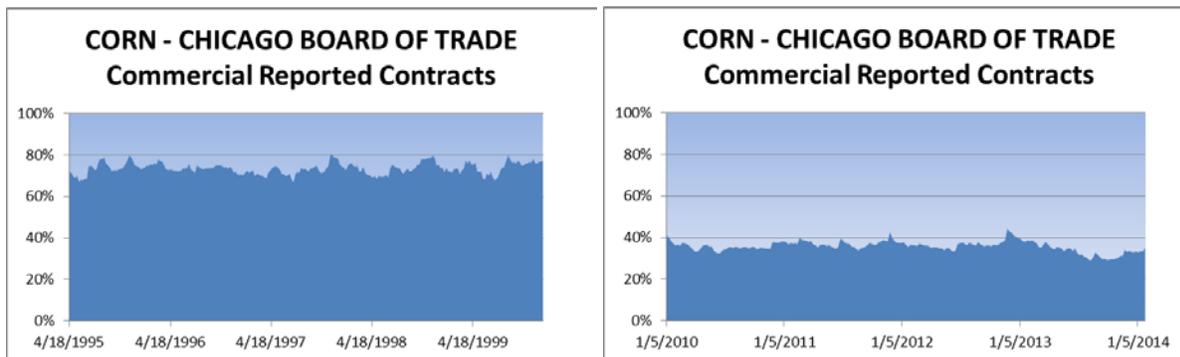
Tellingly, since 2010 an average of 67% of Live Cattle, 69% of Lean Hogs, and an astonishing 74% of Feeder Cattle contracts have been traded by non-commercial speculators, with commercial participants a distinct minority player.

preponderant amount is handled by one hand that it can be made the instrument of manipulation." See Testimony of Dan M. Berkovitz "Position Limits and the Hedge Exemption, Brief Legislative History" citing Testimony of Herbert Hoover, at pages 900, 902 (Jul. 28, 2009), available at http://www.cftc.gov/PressRoom/SpeechesTestimony/berkovitzstatement072809#P19_5690.

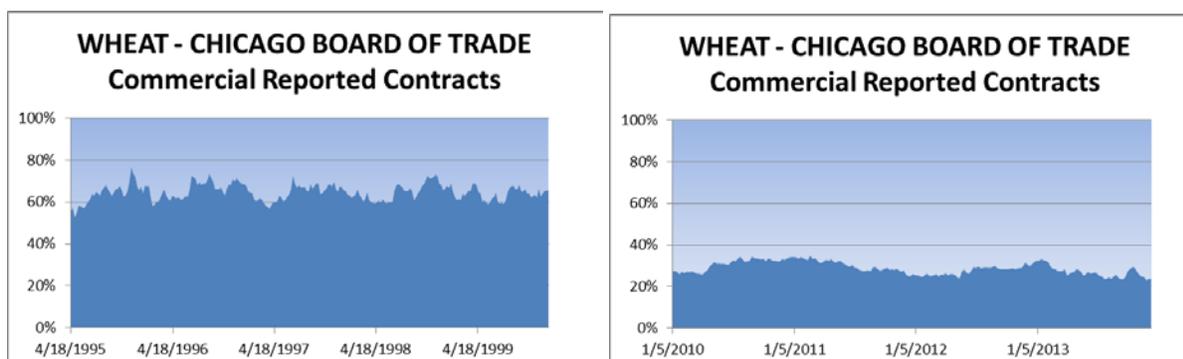
¹⁰ Commercial vs. Non-Commercial contracts calculated from the CFTCs COT report. For a more comprehensive treatment of this issue, see March 28, 2011 Letter.

CBOT Corn¹¹

The dramatic facts illustrated in the charts below are crucial: the longstanding ratio of commercial to non-commercial market activity has completely reversed within a decade – and in many cases, non-commercial activity has come to predominate market open interest for the first time in history. **Commercial interests lost control of their own market.**



CBOT Wheat¹²



One might expect that a derivative price would not maintain fidelity to its underlying product when only a third of its market is exposed to the physical supply and demand.¹³ Indeed, the newly dominant force in commodity derivative markets has often brought with it a substantial pricing disconnect from underlying physical markets in recent years, harming the ability of producers and consumers to effectively hedge their risks through commodity futures.

¹¹ Proportion of Commercial Reported Contracts is calculated as Total Commercial Contracts as a percentage of Total Reported Contracts. 1995-1999 Data is taken from the CFTC Disaggregated Historical COT Futures and Options Report. 2010-2014 Data is taken from the CFTC CIT Supplement report.

¹² *Id.*

¹³ This phenomenon is well established in bond markets as well. For example, naked CDS driving referenced bond yields. See Palladini, Giorgia and Portes, Richard, "Sovereign CDS and Bond Pricing Dynamics in the Euro-area," (Nov. 2011), available at <http://www.nber.org/papers/w17586>.

A New Class of Players Enters Commodity Derivatives: The Rise of Commodity Index Traders

Much of the increase in non-commercial market-share stems from the emergence of a new group of non-commercial traders into futures markets. A significant portion of the speculative activity flowing into futures markets in recent years has come not from traditional speculators seeking profit from short-term price action, but instead from Commodity Index Traders, including commodity exchange trade funds (“ETFs”), Commodity Index Funds (“CIFs”) and other related instruments. Together, they form a new family of investment vehicle with features that demand particular attention and strict oversight.

Over the past two decades, investment advisory and real money management firms have increasingly looked to the commodity markets as a means of diversification in investment portfolios. In response to this demand, investment banks and swap dealers have developed, sponsored, and marketed a class of investment products that provides institutional investors primarily long exposure to commodity markets through derivatives.

CIFs and related products are advertised as an asset class that provides equity-like returns, is uncorrelated to equity returns, and serves as a hedge against inflation¹⁴. And since 2004, more than \$300 billion of institutional investment capital has flowed into commodity markets through this product.¹⁵

The key distinction that makes CITs a unique type of market player is that they are neither commercial players, nor speculative traders in any traditional sense. As institutional investors, the buyers of commodity index products clearly have no physical commodity risk they are looking to offset, yet they do not share the trading objectives of traditional speculators who enter the market to pursue a view on price movements.

The objective underlying CIT trades is strictly to put assets under management to work by purchasing commodity futures contracts. The purchases are programmatically dictated by net inflows to these funds, and are largely divorced from market factors specific to the futures or their underlying commodities. The whole process is driven by modern portfolio theory consultants prescribing their current ideas on appropriate (in their view) asset allocation. We will discuss in more detail the unique qualities of and the unique threat posed by CITs below.

Therefore, the current constituency of derivative market participants is now threefold: commercial hedgers, traditional speculators, and index speculators. In modern markets, the threat posed by speculators has evolved and regulators must treat this new threat with care.

2. The Role of Speculation and Recent Market Structure Changes

The compositional evolution of commodity markets has coincided with a number of broad disruptions to their behavior. The increase in total market volume – driven by an influx

¹⁴ “Investors often look to commodities as a way to potentially gain enhanced portfolio diversification, protection against inflation, and equity-like returns. As such, commodities have gained traction among institutional and retail investors in recent years, either as a separate asset class or as part of a real assets allocation.” See S&P Dow Jones Indices, “Commodity Investments” (Sep. 2012), available at <http://us.spindices.com/documents/research/commodity-investments-missing-piece-of-portfolio-puzzle-201209.pdf>.

¹⁵ See Masters, Michael and White, Adam, “The Accidental Hunt Brothers,” (Jul. 31, 2008) available at <http://www.loe.org/images/content/080919/Act1.pdf>.

of speculation - has tracked both a sharp rise of price volatility, and a convolution of traditional curve shapes of individual commodities. In combination, these factors reflect a futures market that is too often meaningfully untethered from supply and demand fundamentals. Importantly, this calls into question the benefit that is actually provided by this additional speculation.

Thus, determining the appropriate proportion of speculation is crucial for informing the effective design of speculative position limits by the Commission.

Volume Has Exceeded Its Ability to Provide Liquidity to Commercial Hedgers

Net provision and consumption of liquidity in the commodity markets tends to be segregated along business lines.¹⁶ The universe of net liquidity consumers, or “takers,” generally consists of those participants whose need to transact stems from some underlying physical exposure. This group includes producers, merchants, processors, and end-users of a product. The group of net liquidity providers, then, consists of the balance: those participants that have no functional business “need” to transact, and instead buy and sell based on the opportunity to profit from short-term price movements. These latter traders are better known as traditional speculators.

In a balanced market, producers and consumers are aided in their hedging by sufficient speculative interest in looking to profit from price moves. Speculators, unconstrained by commercial needs, can keep markets in check by coming in to sell when futures appear too high, and buy when they appear too low. Speculators can also be buyers when commodity consumers are insufficient to match the future supply of producers, and speculators can be sellers when producers don’t immediately meet the hedging demands of consumers. Put another way, when producers and consumers demand liquidity, speculators can provide it and historically have.¹⁷ **In the correct proportion, speculators facilitate commerce.**

But there is no evidence that the increased speculative activity in the past 10 years - both outright and as a percentage of open interest - has contributed to more orderly markets, increased hedging ability, improved price discovery, or increased liquidity. In fact, there is clear evidence that the reverse has occurred.

¹⁶ Liquidity, despite being a concept widely used across financial markets, remains both poorly defined and poorly measured. A common proxy for liquidity is the behavior of bid/offer spreads as an indication of the level of liquidity in a market. Intuitively, when there are consistently abundant buyers and sellers in a market, competition among buying interests will drive the prevailing bid up while competition among sellers will drive the prevailing ask price down. In a liquid market, the difference between the highest bid and lowest offer will be narrow and steady over time. An optimal level of liquidity is exemplified by a market where buyers and sellers are able to trade frequently by crossing the narrow and steady bid/offer, and speculators are able to profit from collecting these small but frequent transaction costs.

¹⁷ As discussed in a later section of this letter, Commodity Index Funds also consume a large proportion of the short liquidity in the futures markets, but are distinct from commercial hedgers in all other meaningful ways. This distinction lies at the core of the significant risk presented by these funds to the futures market. CITs contain the worst features of all market participants-they are disconnected from underlying supply and demand, yet do not serve to provide liquidity to commercial hedgers-while providing none of the benefits. They are non-commercial liquidity takers.

This should not come as a surprise. As discussed above, there is a level of speculation that efficiently matches the needs of commercial handlers on opposing sides of the market and works to facilitate the transmission of risk between them. But, when considering the fact that hedging interest is limited by the underlying commercial activities of producers and consumers whereas speculative interest is not, there is a fixed amount of facilitation that speculators can provide – and that limit lies at the point that the hedging needs of end-users have been efficiently met.

Every trade conducted transmits information about the trader's views throughout the market. This is fundamental. The information, in aggregate, is the force to which prices move in reaction. Prices do not discriminate based on the class of any individual or any group of traders. As an obvious example, a company's stock price will typically fall in reaction to a large influx of short-selling day traders without regard for a company's strong fundamentals.

As such, a trade by a commercial hedger transmits information about real supply and demand fundamentals throughout the market, and trade by a speculator transmits information about the expectation of short-term speculative price movements. Therefore, the optimal composition of a market is one where hedgers are able to offset **all** of their commercial risk (if they so choose), thereby transmitting the maximum potential information about the fundamental commodity market, with the least amount of intermediation by speculators signaling speculative intent.

Every additional speculator may add some marginal liquidity to hedgers, but in doing so simultaneously dilute the pool of market information to be less reflective of fundamental forces. While bid/offer spreads can only ever approach zero, the dilution of the information pool by speculative trading is unlimited. Therefore, additional volume for which the marginal increase in liquidity is outweighed by the dilutive non-commercial information it transmits is superfluous, and is harmful. **This excess liquidity is not really liquidity at all – it is simply volume.**

We will demonstrate below that **the level of speculation in futures markets has been excessive for many years, and this excess speculation meaningfully affects commodity prices and commodity markets adversely.** Indeed, it has transformed the commodity derivatives market into one where an abundance of speculators trade based on the expectation of price movements caused by other speculators, notwithstanding the need for hedgers to efficiently offset real commercial risk there. This is a hallmark of speculative markets.

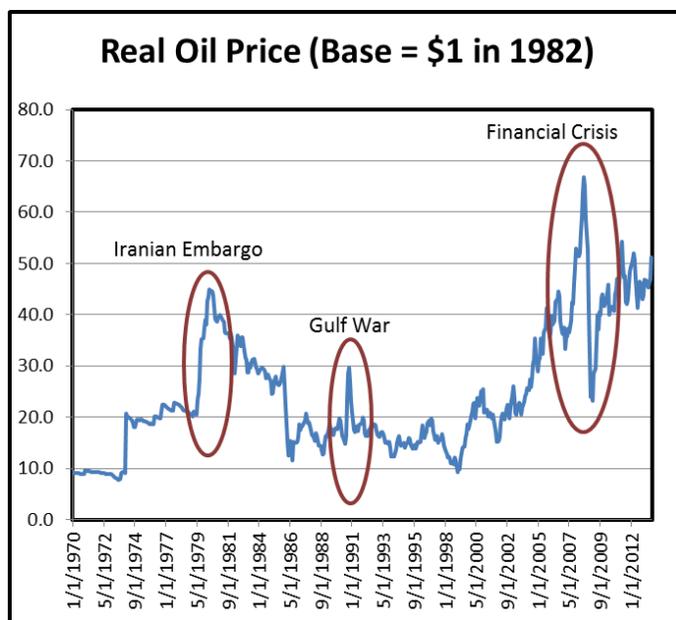
Of course, this is precisely the rationale underlying the historical need for the imposition of position limits: to limit speculation to the level where the liquidity it provides is a net benefit to commerce. The marginal liquidity gains of speculative volume approach zero at some point, and it is up to the regulators to ensure that the level of speculation does not approach or exceed that point.

We Are in the Midst of an Extended Period of Elevated Volatility

The recent influx of speculative volume coincided with a dramatic and sustained increase in commodity price volatility across both physical and derivative markets. A particularly illuminating demonstration of the abrupt and dramatic increase in volatility can

be seen in the chart of crude oil prices over the past 40 years. For context, the volatility in the price of WTI crude since 2000 dwarfs the volatility experienced during both the Iranian Revolution and the Gulf War, historically the most significant real threats to global supply.

Oil Price Volatility¹⁸



It should go without saying that elevated volatility is not a feature of stable or liquid markets. Volatile markets are difficult and costly to navigate, and limit the ability of hedgers to reliably mitigate risk within them. Sustained volatility can often become self-perpetuating as the increased risk of liquidity provision can drive some market makers and traditional liquidity-providing speculators out of the market, further exacerbating the volatility and hedging costs.

While global supply and demand factors and geopolitical uncertainty contributed to the calamitous price volatility in many physical commodities during 2008-2009, **it has been well established that the level of volatility greatly exceeded what could be attributed to fundamental forces.**¹⁹

Clearly, over the past 15 years commodity markets have experienced both dramatically increasing speculation **and** a sharp rise in extra-fundamental volatility. This is a counter-intuitive coincidence. If the additional speculation entering the market during this period were providing beneficial liquidity to commercial hedgers, one would expect this period to demonstrate narrower bid/offers, superior price discovery, and an effectual counterweight to fundamental sources of volatility. Thus, it cannot be said arbitrarily that greater speculative liquidity equals lower market volatility when in fact the reverse can be the case, as above.

¹⁸ From Federal Reserve Bank of St. Louis FRED Database.

¹⁹ See United States Senate Permanent Subcommittee on Investigations Report "Excessive Speculation in the Wheat Market" (Jun. 24, 2009), available at <http://www.hsgac.senate.gov//imo/media/doc/REPORTExcessiveSpeculationintheWheatMarketwoexhibitschartsJune2409.pdf>.

Curve Disruption and Persistent Contango

The conventional curve structure for many commodity futures is downward sloping, with longer-dated futures priced below those near expiration. The economic theory behind this reflects the particularities of commodities markets, which require storage and delivery of physical goods. The price of a commodity three months from now will be based off of today's price less the cost of warehousing those commodities for three months. This curve shape, known as "normal backwardation," is a hallmark of many commodity markets and has persisted across products for decades.

Beginning in the early 2000s, the futures curves of many commodities, such as crude oil and wheat, began to invert as prevailing futures prices rose above spot prices. This inverted state, known as contango, increased in frequency during the early part of the decade, and has persisted almost uninterrupted since 2005. Below, we will discuss how the unique structure of CITs, and specifically their frequent rolls, directly contributes to a contango curve shape across a variety of commodities. Importantly, the contango curve has prevailed primarily during the roll periods in which commodity index participants roll forward their futures contracts.

Decreased Hedging amongst Commercial Participants

As with any hedge, the value of commodity futures as an effective means to offset commercial price risks relies on their correlation and causality to supply and demand. The changing market structure demonstrates some of the ways that futures markets have ceased to accurately reflect the economic forces underlying the physical markets they represent. This compromises the ability of commodities futures to fulfill their role in allowing commercial hedgers to offset their risk.

Hedging as a percentage of production has been decreasing for years²⁰. In explanation of their reduced hedging, commercial hedgers have cited both the decreased correlation between futures and supply and demand, and costly margin requirements on derivatives due to market volatility.²¹ Because the margin required for derivatives hedges increases as market volatility rises, the price to hedge against that volatility rises. Since this raises the cost, the value of a given hedge is reduced. Thus, this situation has a meaningful impact on the physical market. Effectively, the cost of doing business is increased, and that increased cost is then passed on to the ultimate customers of these products.²²

The reduced utility of the derivatives market for hedging demonstrates that the risk of carrying unhedged exposure does not outweigh the cost of offsetting price risk.

²⁰ Please see March 28, 2011 Comment Letter Page 5 for an illustrative graph of production-weighted hedging in wheat markets.

²¹ See Snyder, Brett, "Fuel hedging no guarantee for airlines," CNN.com (Mar. 21, 2011), available at <http://www.cnn.com/2011/TRAVEL/03/21/airlines.fuel.hedging/>.

²² Importantly, the increased cost is felt whether or not the commodity producer decides to hedge his risk or not. Those who choose instead to forego hedging bear the cost of unhedged commercial risk that is ultimately passed on in some other form. A particular example is the use of fuel surcharges by airlines to offset fuel price risk.

Fundamentally, the hedge has ceased to be sufficiently valuable, either because its offsetting correlation is insufficient, or the relative cost of carrying the hedge is too great.

The Futures Market Influences the Physical Market

The transmission of dislocation from the derivatives market through to the physical market beneath is a serious threat, and demands comprehensive attention from regulators. It is important to note, however, that while options, swaps, and futures each are linked to the spot market and may exert influence on it indirectly, futures are uniquely potent in this way. There are several mechanisms by which futures uniquely and directly influence spot prices in ways that swaps and options do not.

First, futures prices serve as a forecast of the spot market. They historically provided a window into the collective expectations of the greater market constituency as to where prices will be in the future, and they are still used as the baseline around which physical auctions are bid and offered. Higher futures prices are taken as an indication that the market expects spot prices to rise, which influences the price the market is willing to pay today.

Additionally, the execution price of many commodity products is explicitly linked to the futures price by contractual convention. For example, forward purchases of jet fuel are settled at the prevailing cash price upon delivery. As there is no exchange market for jet fuel, however, the prevailing cash price is contractually determined by a published index (which prices jet fuel by reference the next-to-expire NYMEX heating oil contract).²³

But perhaps of most import, futures prices serve as price benchmarks by which many grades of physical commodities are traded against (plus or minus some basis spread). Just like heating oil serves as a benchmark for various grades of jet fuel, WTI and Brent crude oil contracts serve as benchmarks for oil grades around the world (with various sulphurs and other physical characteristics). The CBOT grain contracts serve a similar function for various types of wheat in global markets. Since commercial traders tie physical transactions to benchmark futures contracts, when the price changes in the futures market, it is immediately transmitted to physical prices via commercial hedging contract specifications.²⁴

Unfortunately, this common contractual mechanism does not account for the possibility that futures prices are unrepresentative of fundamental factors. If, for example, the price of heating oil futures were subject to undue influence by excessive speculative force, the

²³ See "Platts Oil Pricing and Market-on-Close Methodology Explained," (Jun. 2010), available at <http://www.platts.com/IM.Platts.Content/InsightAnalysis/IndustrySolutionPapers/moc.pdf>.

²⁴ As Platts explains, "Critically, in those markets where commodities trade at differentials to futures, the prevailing futures' value as assessed by Platts at 3:15 pm ET will be used in the assessment process... In the Americas, most physical refined products trade either publication-related or at a differential to an underlying oil futures contract: light sweet crude oil, New York Harbor RBOB gasoline barges, or New York Harbor heating oil barges...Platts has been using relevant information in its assessment processes, including the NYMEX settlement as the basis when deals are done at a differential to futures. Beginning June 1, Platts will use the value of futures at 3:15 pm ET as the basis for these differential based markets." See <http://www.platts.com/IM.Platts.Content/MethodologyReferences/MethodologySpecs/alignmentmethodology2009.pdf>.

disruption would be felt directly by airlines purchasing jet fuel for their fleet, given the ties by commercials to the benchmark contract, as described above.

Commodity derivatives markets, whether physically or cash-settled, in both the spot and non-spot month, have important effects on the prices of actual goods exchanged by commodity producers and consumers. The Commission must appropriately and comprehensively monitor the players in these markets to ensure that non-commercial players don't excessively use derivatives, and particularly futures, to damage the utility of commodity markets for those who need them.

3. Academic Studies Have Demonstrated Excessive Speculation Exists

The Release presents academic studies that fall on both sides of the argument regarding the extent to which excessive speculation is present in the markets today. However, there are major flaws in the Release's approach to the academic literature. The CFTC's analysis fails to take into account that many of the cited papers that find no effect of speculation on prices **are directly or indirectly funded by the very industry that has a significant economic interest in ensuring that effective position limits are not imposed and that speculation continues unlimited.**²⁵ That doesn't mean that studies with conflicts of interest are not considered, but their material interest, which diverges from the public interest and statutory mandate, has to be recognized and the weight accorded them, if any, must reflect that fact.

Furthermore, the CFTC draws no distinction between empirical studies and merely descriptive ones. Thus, purely hypothetical papers drawn along ideological lines and generalizable across all markets at all times are mixed indiscriminately with genuine data-based studies of the commodities markets during the time periods under consideration.²⁶

Finally, there is no indication in the release that the Commission recognizes the asymmetry between empirical papers that find evidence of excessive speculation distorting prices and those that do not. In the medical field and most sciences, a bias towards positive results means that failed experiments are not published. Unfortunately, this is not so in economics and finance.

The existence of multiple papers not finding evidence of excessive speculation is equivalent to physicists publishing several papers that do not find evidence of a particular type of particle. If a different group of physicists were then to publish papers finding evidence that the particle did in fact exist, this would be heralded as a great discovery, and the previous papers would be superseded by this new development.

²⁵ The Commission even cites a working paper by CME group, one of the parties most likely to benefit from weak position limit rules. For more discussion of conflicts of interest, see Kocieniewski, David, "Academics Who Defend Wall Street Reap Reward," New York Times (Dec. 27, 2013), available at http://www.nytimes.com/2013/12/28/business/academics-who-defend-wall-st-reap-reward.html?_r=0.

²⁶ For a purely hypothetical model which assumes that perfectly rational traders ensure perfectly efficient markets in which price bubbles by definition cannot occur, see Ebrahim, Muhammed Shahid, "Can Position Limits Restrain 'Rogue' Trading?" Journal of Banking and Finance (Feb. 3, 2011), available at <http://ssrn.com/abstract=1742450> or <http://dx.doi.org/10.2139/ssrn.1742450>. This is essentially irrelevant to the discussion of the extent to which actual price bubble of 2008 was caused by excessive speculation.

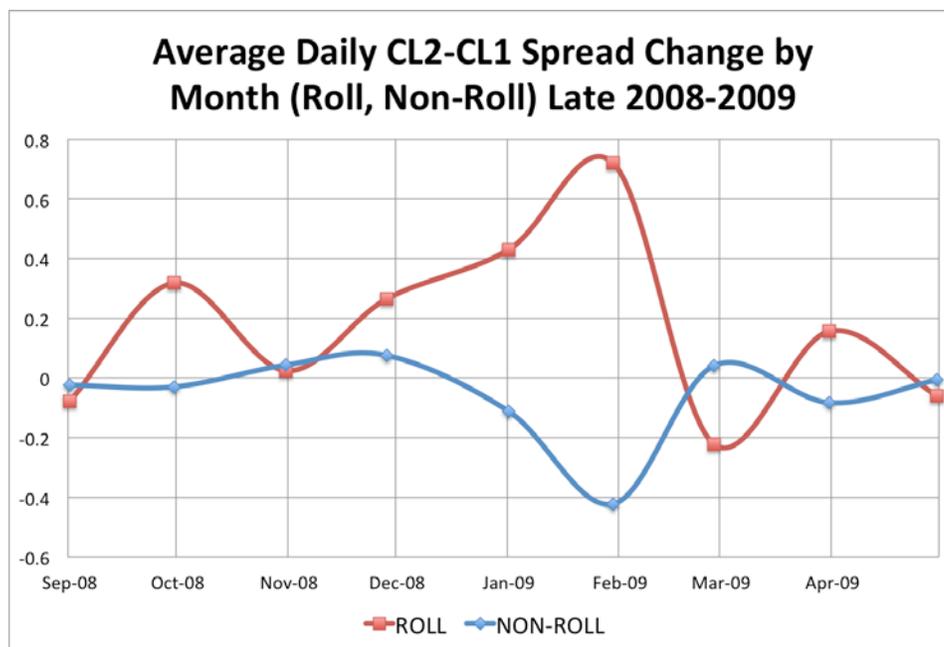
Yet the CFTC cites defunct studies that used inappropriate statistical tools or data samples and found no evidence of speculation impacting prices alongside papers that used appropriate tools and sampling techniques and found strong evidence as though there were no difference between the two. Given the financial industry's vast resources, significant economic self-interest and motives, clearly it can directly or indirectly influence many more studies than can be produced by those academics working without such bias. But truth is not found based on the number of studies conducted or produced, but by the merits of those studies looking at the evidence only based on the facts.

The crucial point to note is that **finding no evidence** of a speculative impact on prices is not the same as **finding evidence** that speculation **had no impact**. Thus, for instance, contrasting studies like Irwin and Sanders (that looked at weekly returns and found no impact of Commodity Index Trader flows on prices) with others like Singleton (that looked at quarterly returns and found significant impact) should cause one to conclude that the latter group supersedes the former. Irwin and Sanders did not find evidence of a speculative effect because they looked in the wrong place. Singleton looked over a different time frame and found the effect. Once the particle is discovered, it cannot be undiscovered.

Better Markets' Analysis Demonstrates that Excessive Speculation is Still Distorting Markets

The Release cites a 2011 Better Markets study that demonstrated that Commodity Index Trader behavior was distorting price curves in several major commodities including crude oil and wheat. A recently updated analysis has shown that these effects are still occurring, demonstrating the need for decisive action by the Commission to restrict or eliminate commodity index trading practices.

As the 2011 paper demonstrated, crude oil and other commodities have been pushed into contango on days when the Goldman Roll takes place, even when fundamentals suggest prices should be backwardated, a fact confirmed by price behavior on non-roll days. This distortion was especially pronounced during the crisis of 2008-2009:



In February 2009, the spread between the second month NYMEX WTI Crude Oil contract (which the CITs were buying) and the front month NYMEX WTI Crude Oil contract (which they were selling) increased by an average of 72 cents per day. The two days before the roll, when arbitragers were putting on positions in anticipation of the predictable upcoming roll, the spread increased by a further 30 cents, leading to **a total contango increase of almost \$4 during one roll alone.** To put this in context, WTI was trading at around \$40 at this time, meaning **a single roll was able to generate a contango equivalent to 10% of the price of crude oil.**

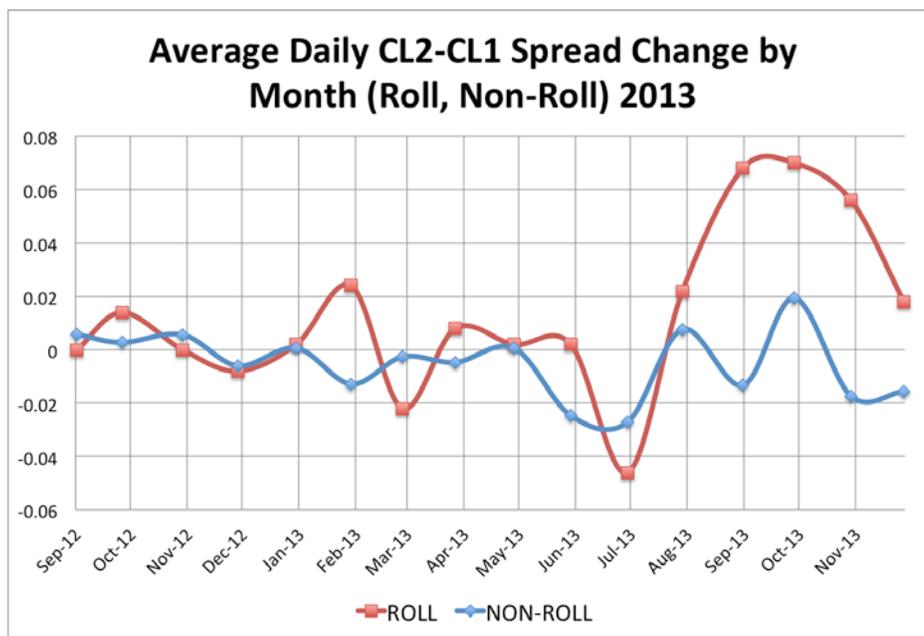
In contrast, on the remaining days of February the spread was narrowing by an average of 42 cents per day. Tellingly, the spread widened on 6 of the 7 trading days comprising the roll and pre-roll. In contrast, the spread widened on only 5 of the 14 other trading days that month (on which neither roll nor pre-roll arbitrage trading were occurring).

This pattern was not unique to February 2009. During those crisis months, it was common to see contango widening absurdly just before and during the monthly Goldman Roll, then gradually narrowing during the rest of the month (though rarely enough to balance out the distortion generated during the Roll).

This contango bias is hugely damaging. Not only does it push up the price of the second month contract (which, in time becomes the spot month contract, dragging up spot prices when it does so), but it also distorts supply and demand in physical markets. A contango price curve creates an incentive for producers to delay production, and for consumers to stockpile. This puts additional upward price pressure on physical markets leading to higher energy prices for businesses and households.

Since energy prices are a key component of food prices due to their impact on production and distribution costs, this also increases the price of food. Finally, an artificial contango bias encourages producers to invest in more future production, even if the true long-term fundamentals of supply and demand do not warrant this. Unfortunately, this can lead to eventual oversupply, causing additional volatility as prices are eventually pushed down.

This pattern of artificial contango emerging during the Goldman Roll corrected during 2011 and 2012, perhaps as a result of CIT redemptions that reduced the volume of CIT trading during those years.²⁷ However, it has recently re-emerged during the second half of 2013:



This suggests that the problem has not gone away, and that it will not do so until the CFTC acts to sharply curtail CIT trading.

4. Commodity Index Traders

History and Overview

Following a decade of deregulation and a painful correction in the stock market, the early 2000s saw a boon of new financial products aimed at institutional investors looking to diversify their portfolios²⁸. The effort to bring commodity speculation into the mainstream followed the publication of an academic paper (sponsored by AIG, at the time a swap dealer with an interest in promoting swaps trading in commodities) that showed how the historical returns on a basket of commodity futures was negatively correlated to equity returns, and positively correlated with inflation²⁹. This paper provided “academic support” to enterprising swap dealers and a roadmap to new product creation and sales. They began by structuring large baskets of commodity futures contracts, and then creating swaps to provide commodity

²⁷ See Larkin, Nicholas, “September Commodity Outflows Hit \$10 Billion,” Bloomberg.com (Oct. 12, 2011), available at <http://www.bloomberg.com/news/2011-10-21/september-commodity-outflows-hit-10-billion.html>.

²⁸ For detailed discussion and analysis of Commodity Index Funds, see Better Markets Report, “Commodity Index Traders and the Boom/Bust Cycle in Commodities Prices,” (Oct. 2011), available at <http://www.bettermarkets.com/sites/default/files/BM%20Report%20CIF%20FINAL.pdf>. For an in-depth discussion of market-based relationships between excessive speculation and commodities prices, see Masters, Michael and White, Adam, “The Accidental Hunt Brothers,” (Jul. 31, 2008) available at <http://www.loe.org/images/content/080919/Act1.pdf>.

²⁹ The academic paper was Van Rowenhorst, K. Geert, and Gorton, Gary, *Facts and Fantasies About Commodity Futures*, 2004 (funded by AIG Financial Products). The increase in index fund popularity is detailed in Basu and Gavin at pages 43-44 available at http://www.nber.org/papers/w10595.pdf?new_window=1.

exposure to institutional investors. With this, Commodity Index products were pushed to a large variety of institutional investors.

CITs promised equity-like returns, portfolio diversification, and a hedge against inflation. Importantly, CITs are **not** marketed as a vehicle for investors to take a view on the fundamental supply or demand of any particular commodity, or even the commodity market as a whole: the factors underlying an investment in CITs are distinct from the factors underlying a commodity trade. They are geared to support investment consultants' foray into "alternatives" and current views on asset allocation based on modern portfolio theory.

Depicting tradable commodity futures as an "investment", however, is disingenuous and misleading.

Capital markets exist for the purpose of allocating investment capital to businesses, which then use that capital to grow and produce. An actual capital investment in commodities would involve purchasing the equity of an oil refinery, or lending to a copper mining company through the bond market. Through the capital markets, investor funds are allocated to facilitate the production of goods and services, and investors receive returns that reflect the increased productivity they have financed. This is, of course, a paramount distinction between commodity markets and capital markets. Commodities are not a productive asset, and so they cannot create wealth over time. In practice, one's retirement capital is "invested" in commodities in the same way that their paycheck is "invested" in groceries.

Notwithstanding the false economic framing and misleading packaging, what followed was a dramatic inflow of investment capital to the commodity markets through CIFs, ETFs and other CIT products. In aggregate, Commodity Index Traders now comprise the single largest group of non-commercial participants in commodities futures markets, at times even outweighing both *bona fide* hedgers and traditional speculators in market share.

To appreciate the scope of the impact CITs may wield on the underlying futures markets, it is crucial to consider some of their unique qualities.

CITs Are Long-Only and Long-Term

Large pools of institutional capital are put to work by buying short-dated commodity futures contracts which are perpetually rolled forward to maintain duration and avoid expiration. Therefore, the fund exposure is always long across all constituent contracts. The amount of futures contracts purchased is determined exclusively by the amount of investor capital in the fund; sales of futures contracts are only made to reflect outflows from the fund. Further, as one might expect in a product serving as a hedge against inflation, much of the institutional cash is allocated to these funds as a long-term investment. The market implications of these factors are substantial.

In practice, these funds are interpreted by the futures market as a massive amount of demand locked away for an indefinite period of time³⁰. Although this does not reflect real

³⁰ Before the Senate Permanent Subcommittee on Investigations, Thomas Coyle, the chairman of the National Grain and Feed Association, echoed this point. "These positions held by commodity index traders are primarily long only, held for extended periods, and are not responsive to changes in price. We believe this situation, in which a large portion of the open interest is not for sale at any price for extended periods, has

interest in physical purchases, the demand for futures meaningfully impacts the real underlying supply and demand curves. **While there must always be a willing seller for these funds to transact, the price those sellers are willing to accept in exchange increases in the face of increased demand.** Put another way, over time these funds have structurally pushed up the price of futures, and consequently contributed to the rise in physical commodity prices.

It is important to contemplate what this means over a longer-term horizon. Consider a scenario where a CIT were to liquidate a large percentage of the funds under management. Technically, this would entail the facilitating swap dealers to allow a percentage of outstanding futures contracts to expire, instead of rolling them into a new contract before expiration.

To the market, this would translate into a dramatic increase in net future supply, as sellers who have become accustomed to a regular large institutional bid at the existing price, would be left without a buyer to accommodate them. Sellers would then have to lower their ask prices to be filled in the absence of the (artificial) demand created by CITs. Just as the massive buying of CITs has structurally driven prices up, a massive unwind of these positions would drive prices back down as CIT swaps were liquidated via selling in the futures markets.

CITs Are Programmatically Liquidated and Reinvested ("Rolled") into a Longer-Dated Contract on a Predictable, Frequent, and Regular Basis

The process by which CITs provide investors with hassle-free exposure to a basket of commodities involves regular maintenance trades in the derivatives market. In practice, an investment in a CIT is a share of a total-return swap between the fund manager and a swap dealer, which exchanges some fixed rate for the net returns on a basket of futures contracts.

As the funds provide perpetual exposure to contracts near expiration, the facilitating swap dealer must regularly unwind these contracts before expiry and enter into equivalent longer-dated contracts. Put another way, several times each year the entire portfolio is liquidated and immediately reconstituted with slightly longer-dated contracts. It shouldn't be surprising to unbiased observers why the financial services industry has been sharply critical of regulatory efforts to restrict CITs, given the amount of trades necessary to create these structures for investors. Because all costs are passed along to the investor in the CIT, all this trading is clearly very profitable for the sponsoring swap dealers that benefit from these commodity index transaction volumes.

What this means is that CITs present a regular large offer on the very short-dated contract, offset by a persistent large bid for a longer-dated one. To the term-structure of the futures curve, this position is a classic commodities forward curve "steepener", and has contributed to a persistent steepening of the futures curve across many commodities since CITs have become a significant force in the markets.

As discussed above, the physical market relies heavily on the futures curve to form market expectations and price forward deliveries. The mechanical re-engineering of the

drained liquidity out of the contract and contributed to extreme volatility," available at <http://www.hsgac.senate.gov/download/stmt-coyle-nat-grain-and-feed-assocjuly-21-09-psi-hrg>.

futures curve by CITs has interfered with its capacity to indicate future supply and demand of physical commodities. Indeed, as demonstrated by the persistent state of contango, many commodity futures curves now unhelpfully reflect the asset allocation appetite for investment diversification or inflation hedging by non-commercial investors, rather than the forces of supply and demand

*CIT Investment Decisions Are **Price-Insensitive**, and Disconnected from Supply and Demand*

Index funds increase or decrease their purchases based exclusively on net inflows to or outflows from the fund, and without regard to a directional view on the price of any given component or the index as a whole.³¹ Recall that CITs are effectively a basket of futures contracts that mirrors the size of the fund. When new investment capital flows into the fund, additional futures of an equivalent amount are purchased in the basket portfolio, regardless of price. The hedge basket is not actively managed outside of periodic rebalancing with the index, and the portfolio is **not** designed to reflect market movements. Purchases are made when money flows in, and sales are made when money flows out; in neither situation do the futures trades depend on price. Thus, CIT trades are independent of both the futures prices, and physical supply and demand.

In addition, studies have shown that commodities included in these indices are subject to the “index effect”, whereby futures that are included in the basket develop technical price correlation with each other. In fact, index activity significantly increases correlations between commodity prices and equity prices as a class³², as well as correlations amongst individual commodities (often with no fundamental relation to each other).³³ Separately, studies have demonstrated that index activity transmits price action even to other non-index commodities.³⁴

³¹ By extension, this is also the case for the trades of the sponsoring swap-dealers in connection with facilitating and offsetting the CITs exposure in the futures market.

³² “We have found that in the presence of institutions futures prices of all commodities rise, with futures prices of index commodities increasing by more. We have also found that in the presence of institutional investors shocks to fundamentals (demand and supply) of index commodities get transmitted to prices of all other commodities. Furthermore, the volatilities of all commodity futures rise in the presence of institutions, with those of index commodities increasing by more. These effects are more pronounced in the presence of demand shocks. Finally, the presence of institutions leads to an increase in the cross-commodity and equity-commodity correlations, with those for index commodity futures increasing by more.” Basak, Suleyman, Pavlova, A Model of Financialization of Commodities”, (May 10, 2013) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2201600.

³³ “A consequence of the streams of research that have suggested that increased financial engagement in commodity futures will link commodity returns more closely to equity indices (Tang and Xiong, 2012; Banuayanuksahin and Harris, 2011; Singleton, 2013) and that index-focused investment by itself may increase the correlations amongst the assets within the index (Basak and Pavlova, 2013), is the expectation that financial flows into commodities may also manifest increased correlations between actively traded commodities. We tested this on U.S. oil and gas futures and find support for the conjecture. Moreover we find significant evidence that speculation, with its focus on index trading, increases the correlation between oil and gas, whilst hedging, which is based more on individual forward contracts, actually decreases this correlation. Both of these are plausible effects and consistent with the “financialization observations”. See Bunn, Derek, Chevallier, Julien, Le Pen, Yannick, and Sevi, Benoît FUNDAMENTAL AND FINANCIAL INFLUENCES ON THE CO-MOVEMENT OF OIL AND GAS PRICES, available at <http://www.creden.univ-montp1.fr/downloads/cahiers/CC-13-09-100.pdf>.

³⁴ “Collectively, these three findings indicate that commodity index futures impact non-index commodities through index-linked commodities. In other words, commodity index futures have pricing effects on

Excessive speculation, largely driven by CITs, now exists at a level that directly influences the price of the underlying commodities and therefore compromises the price discovery function of the derivatives market.

CITs Do Not Provide Liquidity

Taken together, these qualities demonstrate that **CITs do not provide liquidity to hedgers, and on the contrary they are net liquidity takers.**

As discussed above, volume above and beyond what is required to facilitate commercial hedging does not benefit market liquidity, and importantly the volume provided by long-only passive index funds does not provide useful or necessary liquidity to the market. To the extent that the needs of short commercial hedgers coincide with the pre-determined buying schedule of CITs, they will incidentally provide offsetting interest. But this does not satisfy any meaningful understanding of useful liquidity provision.

In reality, index funds compete with long hedgers for available short liquidity in the market because they interact in futures markets as would a commercial participant with large perpetual demand. CITs are bound by their investment strategies to purchase or roll their position according to a schedule and without consideration for the price of any component contract. CITs enter the market to fulfill an investment need, on a predetermined schedule, at whatever price is available. This is the paradigm example of a liquidity taker.³⁵

5. The Proposed Rule

The Commission Must Craft a Rule that Achieves All of Congress' Goals

For nearly 150 years, commodity futures markets have existed to serve two major functions: 1) offsetting the price risk of physical market exposures, and 2) facilitating price discovery for commodity market participants. Congress has enshrined these objectives in the law since the 1936 passage of the Commodity Exchange act, and the CFTC in particular has been deputized to preserve these functions since its creation in 1974.³⁶

individual commodity prices and these effects are not likely explained by fundamental forces (e.g. supply and demand) or non-synchronous trading bias. Our fourth finding is that the extent of index-linked to non-index price pressures is positively related to the amount of speculative activity, both long and short, in the S&P GSCI commodity index futures contract." See Tse, Yiuman and Williams, Michael R. "Does Index Speculation Impact Commodity Prices? An Intraday Futures Analysis" (YEAR) available at <http://www.olemissbusiness.com/financialReview/documents/Does%20Index%20Speculation%20Impact%20Commodity%20Prices.pdf>.

³⁵ Note that even in the presence of perfect arbitrage, this would still have a temporary distorting impact on the market due to the time it takes to arbitrage out. However, in a real life situation where there are limits to arbitrage, the effects are more pervasive and pernicious.

³⁶ "Through effective oversight, the CFTC enables the futures markets to serve the important function of providing a means for price discovery and offsetting price risk." CFTC Mission Statement <http://www.cftc.gov/about/missionresponsibilities/index.htm>.

In amendments to the Commodity Exchange Act resulting from the Dodd-Frank Act, the Commission has been specifically mandated to impose speculative position limits to achieve four distinct and separate goals:

- (i) to diminish, eliminate, or prevent **excessive speculation**;
- (ii) to deter and prevent market manipulation, squeezes, and corners;
- (iii) to ensure sufficient market liquidity for *bona fide* hedgers; and
- (iv) to ensure that the price discovery function of the underlying market is not disrupted.³⁷

It is clear from these explicit criteria that Congress sees four distinct threats to commodities markets, and that each is to be addressed in the comprehensive imposition of position limits by the CFTC.

Certainly, the straightforward enumeration cannot be interpreted to suggest that satisfying a single criterion would deem the others superfluous. For example, there is no reason to believe that the promotion of liquidity alone would also prevent market manipulation by extension. Protecting liquidity for hedgers and preventing market manipulation are distinct and equally important goals. **Proposing a regime that achieves one while disregarding the others is an indefensible failure to meet the unambiguous aims of Congress.** Indeed, it would be an abdication of regulatory responsibility and a violation of the law.

Judged by this standard, the Position Limits Rule, as proposed, is largely a failure. Specifically, the Commission has taken to describe, set, and justify position limits that **exclusively** aim to prevent extraordinary instances of market manipulation³⁸, while failing to address non-manipulative behavior that would result in excessive speculation, insufficient liquidity, or impaired price discovery.³⁹

The extraordinary disruptions experienced during the Hunt Brothers manipulation of the silver market or Amaranth's more recent cornering of the natural gas market (the two demonstrative episodes used by the Commission to show the necessity of position limits) contained all four elements listed above, but any manipulation on such a huge scale would of course disrupt the orderly function of markets in multiple ways. Indeed, excessive speculation, insufficient liquidity, and impaired price discovery function are often inevitable consequences of market manipulation.

Manipulation in all cases is explicitly prohibited in the Commodity Exchange Act, and, indeed, Dodd-Frank expanded the Commission's authority in this area by also

³⁷ CEA section 4a(a)(3); 7 U.S.C. 6a(a)(3).

³⁸ As discussed below, it is questionable whether the Proposed Rule, as written, even adequately addresses this single criterion. For example, the Proposed Rule would not prevent or deter the market manipulation conducted in the 2011 Parnon Energy case, where the firm used the physical market to manipulate the settlement price of their futures position. <http://www.cftc.gov/PressRoom/PressReleases/pr6041-11>.

³⁹ This point was illuminated in the Preamble of the Proposed Rule, when referencing the views of a former Commission Chair. "Former Commission Chair Philip McBride Johnson told Congress that position limits were "predicated on several different sections of the Commodity Exchange Act which pertain to orderly markets and the terms 'manipulation, corners or squeezes' refer to only one class of market disruption which the limits established under this rule are intended to diminish or prevent." Fed. Reg. 75,693.

prohibiting other disruptive trading practices.⁴⁰ These prohibitions do not depend on the class or affiliation of the market participant; they apply to both commercial and non-commercial traders, speculators, and commercial hedgers alike.

Position limits were **not** intended to be limited to the prevention of market manipulation. They were crafted to be the means of reducing the burden on interstate commerce that specifically arises from speculative activity. While speculative activity conducted with an aim to manipulate prices would undoubtedly put a burden on commerce, it is only one example of such activity. The burden caused by the cumulative effect of smaller speculators acting in tandem may be just as significant—and potentially much greater than—that of a single actor with manipulative intent.

Congress clearly intended position limits to be designed to limit a variety of harmful activities, including outright manipulation **as well as those instances of excessive speculation that may not be intentionally manipulative**. In the preamble to the Proposed Rule, the Commission acknowledges this point, yet fails to include any examples of such activity in their necessity finding, and fails to propose position limits that could reasonably be expected to address such activity. Here we provide just two examples of such non-manipulative yet excessive speculation that were not taken into consideration by the Commission in their necessity finding.

As set forth in its exhaustive 2009 report on Investigations on Excessive Speculation in the Wheat Market, the Senate Permanent Subcommittee on Investigations:

“examined how the activities of many traders, in the aggregate, have constituted excessive speculation in the wheat market. To prevent this type of excessive speculation, this Report recommends that the CFTC phase out waivers and exemptions from position limits that were granted to commodity index traders purchasing wheat contracts to help offset their sales of speculative financial instruments tied to commodity indexes.”⁴¹

The Dodd-Frank Act *de facto* adopted this recommendation and, in fact, did so broadly. Yet, despite this clear Congressional determination, and the specific guidance on how position limits might be used preventatively, the Proposed Rule fails to state the necessity of a position limits regime that addresses this egregious market-distorting conduct, and fails to propose a regime that would address such excessive speculation in practice.

Further, the Commission acknowledges the incredible 2008 price swings experienced in the crude oil market, an episode that perhaps most clearly demonstrates potential damage inflicted by non-manipulative excessive speculation. In addition to abundant academic and

⁴⁰ Manipulation: CEA section 9, Disruptive Trading Practices: Dodd-Frank Act § 747 *See also* Better Markets Comment Letter, “Antidisruptive Practices Authority”(Jan. 3, 2011), *available at* <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=42710&SearchText=better%20markets>

⁴¹ Senate Permanent Subcommittee on Investigations on Excessive Speculation in the Wheat Market, *available at*: <http://www.hsgac.senate.gov//imo/media/doc/REPORTExcessiveSpeculationintheWheatMarketwoexhibitschartsJune2409.pdf>.

other external studies, reports, and comments on this point, Congress's own investigation studied and concluded that excessive speculation significantly contributed to the extreme volatility of the 2008 oil markets⁴².

In the preamble, the Commission credits the investigation as finding "evidence suggesting that speculation was responsible for an increase of as much as \$20-\$25 per barrel of crude oil."⁴³ Indeed, the magnitude of the commodity price volatility in 2008 and the resulting global market impact was an impetus for Congress to reevaluate regulatory efforts to curb excessive speculation even prior to the 2010 Dodd-Frank Act.

Importantly, the Commission clearly cites this Congressional investigation as analogous to conducting its own investigation for the purposes of the necessity finding:

"Thus, these investigations had already gathered evidence regarding the impact of excessive speculation, and had concluded that such speculation imposed an undue burden on the economy. In light of these investigations and conclusions, it is reasonable for the Commission to conclude that Congress did not intend for it to duplicate investigations Congress had already conducted, and did not intend to leave it up to the Commission whether there should be federal limits."⁴⁴

Thus, it is unacceptable that the Commission proceeded to set position limits at a level too high and too narrowly applied to prevent the very disruptive behavior it has cited here.

Position Limits that effectively limit the threat of excessive speculation must be set at a level significantly lower than that which would limit market manipulation alone. The limits must account for the cumulative effect of identical speculative positions that may not be excessive on an individual basis but constitute excessive speculation in the aggregate⁴⁵. The Commission failed its statutory mandate to use its ample authority to limit the activity that produced the most systemically disruptive event of the past decade in the commodity markets, and the Commission must swiftly correct this failure.

⁴² For a list of studies, see http://www2.weed-online.org/uploads/evidence_on_impact_of_commodity_speculation.pdf. See also Permanent Subcommittee on Investigations Report "*The Role of Market Speculation in Rising Oil and Gas Prices: A Need to Put the Cop Back on the Beat*," S. Prt. 109-65 (June 27, 2006), available at https://bulk.resource.org/gpo.gov/prints/109/s_28640.pdf.

⁴³ Release at 75,682.

⁴⁴ *Id.*

⁴⁵ Please see Better Markets Comment Letter "Aggregation of Positions" (Feb. 10, 2014), available at <http://www.bettermarkets.com/sites/default/files/CFTC-%20CL-%20Aggregation-%202-10-14.pdf>.

Commodity Index Funds Must Be Subject to Strict Speculative Position Limits

Within the universe of non-commercial activity in commodity markets, CITs are uniquely disruptive and must be considered separately from the traditional pool of speculators in commodity markets. As a class of trades, CITs clearly fall within any reasonable understanding of excessive speculation, including in particular the definition provided in section 4a(a)(1) of the CEA.⁴⁶ Congress determined that excessive speculation through CITs contributed to the unprecedented volatility in both the oil and wheat markets, and this presented a significant burden on interstate commerce.⁴⁷

It is inconceivable that regulating CITs would not be a top priority for the Commission. But they remain outside the scope of the position limits in the Proposed Rule. This must be remedied. Congress's findings supplement an extensive collection of academic data, market research, and testimonies of market participants who have demonstrated the incredible threat posed by CITs. In light of the abundant supporting evidence, the onus of proof should be on those who dispute this claim—and they have thus far failed to provide such evidence (as opposed to purchased “studies” that are not evidence-based or that do not address the existing contrary evidence).

The Commission is empowered with explicit statutory authority to impose position limits on CITs. The CEA was modified to **strengthen** aggregation requirements by applying them to contracts in the same underlying commodity and to economically related contracts, across all venues. Additionally, in connection with the position limits set out in Section 737 of the Dodd-Frank Act, Congress included the following provision:

“[S]uch limits upon positions and trading shall apply to positions held by, and trading done by, two or more persons acting pursuant to an expressed or implied agreement or understanding, the same as if the positions were held by, or the trading were done by, a single person.”⁴⁸

⁴⁶ CEA 4a(a)(1) “sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity” as an indication that excessive speculation may be present in a market for a commodity.” Release at 75,688.

⁴⁷ Wheat: “This Report finds that **there is significant and persuasive evidence to conclude that these commodity index traders, in the aggregate, were one of the major causes of “unwarranted changes”** – here, increases – in the price of wheat futures contracts relative to the price of wheat in the cash market. The resulting unusual, persistent, and large disparities between wheat futures and cash prices impaired the ability of participants in the grain market to use the futures market to price their crops and hedge their price risks over time, and therefore **constituted an undue burden on interstate commerce**. Accordingly, the Report finds that the activities of **commodity index traders, in the aggregate, constituted “excessive speculation”** in the wheat market under the Commodity Exchange Act” (Emphasis added), *available at <http://www.hsgac.senate.gov/subcommittees/investigations/hearings/excessive-speculation-in-the-wheat-market>*.

Oil: “In its 2006 Report, “*The Role of Market Speculation in Rising Oil and Gas Prices: A Need to Put the Cop Back on the Beat*,” S. Prt. 109-65 (June 27, 2006), the Subcommittee investigation found that influx of billions of dollars into the U.S. energy markets through commodity index funds had contributed to the rise in energy prices, and that the large influx of speculative investments in these markets had altered the traditional relationships between futures prices and supplies of energy commodities, particularly crude oil”, *available at <http://www.hsgac.senate.gov/subcommittees/investigations/hearings/excessive-speculation-in-the-wheat-market>*.

⁴⁸ 7 U.S.C. § 6a(a)(1).

It is clear that the large universe of CITs, which trade en masse with respect to an explicit common index strategy, would satisfy this provision.

There is no possible explanation, nor has the Commission provided an explanation, to exempt CITs from the proposed position limits. In the preamble to the vacated Position Limits rule, “Vacated Part 151”, the Commission explains that it lacks sufficient experience in applying limits to a “group or class of traders” and therefore would not be setting such limits in the rule.⁴⁹ **Congress did not permit the discretion of the Commission to apply limits to those areas where they have sufficient experience.** The Commission does not have the authority or power to pick and choose those parts of a statute that it wishes to implement. This is an unacceptable abdication of responsibility and violation of the law.

Further, it is overwhelmingly clear that the application of position limits to CITs and the swaps and futures offsetting the risks of these traders would indeed satisfy all remaining statutory criteria as mandated by Congress. Comprehensive application of Position Limits to CITs alone will meaningfully combat excessive speculation and offer a partial remedy the substantial inadequacies of the Proposed Rule.

Subjecting CITs to Position Limits Would Diminish, Eliminate, or Prevent Excessive Speculation

The existing level of speculation in commodity markets is excessive – and in recent times has approached crisis levels. The Commission is mandated to use its authority to reduce the harmful speculation that has caused vast disruption to commodity markets. The Proposed Rule aims to set speculative position limits so high and narrowly applied that they will fail to diminish, eliminate, or prevent any excessive speculation that is not incidental to extraordinary market manipulation.

Despite the incredible fact that very few traders would exceed the limits as currently proposed, CITs would collectively exceed the limits if appropriately aggregated according to the statute. Bringing the **class** of CITs within the scope of speculative position limits, even at their current exorbitant level, could produce a meaningful reduction of excessive speculation and thereby satisfy the first statutory objective.

⁴⁹ Vacated Part 151 Final Rule, 11/18/11 – Fed. Reg. 71,657: “Historically, the Commission has applied position limits to individual traders rather than a group or class of traders, and does not have a similar level of experience with respect to group or class limits as it has with position limits for individual traders. Therefore, the Commission believes more analysis is required before the Commission would impose a separate position limit regime, or establish an exemption, for a group or class of traders, including CITs. The Commission welcomes further submissions of studies to assist in subsequent rulemakings on the treatment of various groups or classes of speculative traders.”

Subjecting CITs to Position Limits Would Ensure Sufficient Market Liquidity for Bona Fide Hedgers

CITs compete with hedgers by demanding and consuming the liquidity provided by non-index speculators in the market. Any reduction of CIT activity will unencumber and expand the capacity of existing speculators to intermediate on behalf of commercial hedgers.

Subjecting CITs to Position Limits Would Ensure That the Price Discovery Function of the Underlying Market is not Disrupted.

The price discovery function has been seriously inhibited by CITs as they have become an increasingly dominant force in the derivatives market. Their price insensitive, long-only, long-term structure has structurally pushed prices higher by exhibiting a large perpetual demand in markets over many years. Programmatic large-scale rolling has pushed commodities futures forward curves into a contango shape unrepresentative of actual future fundamentals. The “index effect” has raised correlations amongst all commodities within the index, obscuring the individual supply and demand forces, and their resulting price action, inherent to each one. CITs influence prices away from fundamental factors in multiple ways, each of which disrupts the ability of futures to provide valuable price information to hedgers.

Reducing and regulating the influence of CITs would greatly help to restore the true price discovery function in the market.

SPECIFIC SUGGESTIONS TO ADDRESS CIT CONCERNS IN THE PROPOSED RULE

Index Funds Must Be Specifically Included in the Definition of Reference Contract

The most straightforward and commonsense way for the Commission to fix the Proposed Rule, to satisfy the Congressional mandate and the spirit of the law, is to include “commodity index contract” in the definition of “reference contract”. The existing definition of “referenced contract” in § 150.1 includes “commodity index contracts”, and the Commission has provided no justification for its exclusion now.

The Commission reduced its discussion of this important issue to a single uninformative footnote in the preamble of the Proposed Rule. The footnote acknowledges the existence of concerns from commenters, Congress, and the Commission itself,⁵⁰ and states that while it “continues to consider” these concerns, it declined to address them in this rule. Further, the footnote acknowledges the abdication of responsibility in failing to limit the excessive speculation caused by CITs:⁵¹

“..index speculators remain unconstrained on the size of positions in diversified commodity index contracts that they can accumulate so long as they can find someone with the capacity to take the other side of their trades.”

We urge the Commission to reconsider the ample evidence it has received in studies, comments, testimonies, and reports demonstrating the harmful and disruptive effects of CITs on the futures market. As Better Markets and many others have demonstrated, commodity index products are enormously influential within the futures markets, and must be considered a “reference contract” and brought within the scope of the rule.

The Final Rule Must Aggregate on Contract Class

Speculative limits should apply separately to each contract class. Swaps futures and options should be aggregated and subject to position limits separately from OTC swaps, as well as on a combined basis. While the issue of aggregation is treated in greater detail in the aggregation comment letter submitted by Better Markets on February 10, 2014,⁵² the proposed aggregation structure is inappropriately embedded into the Position Limits Proposed Rule and thus deserves mention in this capacity.

The inclusion of pass-through swaps and offsets within the definition of *bona fide* hedge is appropriate, and is consistent with the spirit of the rule by encouraging

⁵⁰ The Commission references the Senate PSI Wheat Report and the CFTC Staff Report on Commodity Swap Dealers & Index Traders with Commission Recommendations (Sep. 2008) at 13– 15 (“Index Trading Report”), the Testimony of Michael W. Masters before the Commodity Futures Trading Commission, Aug. 5, 2009, *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/hearing080509_masters.pdf; *See also* March 28, 2011 Letter.

⁵¹ “Index trading activities have emerged as an area of special concern to both Congress and the Commission. *See generally* the Wheat Report and the Index Trading Report. The Commission continues to consider the concerns of commenters who argue that some transactions and positions recognized before the Dodd-Frank Act as bona fide hedging may, in fact, facilitate excessive speculation... The speculative position limits that the Commission now **proposes do not directly address these concerns as they relate to commodity index funds**, commodity index speculation and passive investment in the commodity derivatives markets. The speculative position limits that the Commission proposes apply only to transactions involving one commodity or the spread between two commodities (e.g., the purchase of one delivery month of one commodity against the sale of that same delivery month of a different commodity). They do not apply to diversified commodity index contracts involving more than two commodities. **This means that index speculators remain unconstrained on the size of positions in diversified commodity index contracts that they can accumulate so long as they can find someone with the capacity to take the other side of their trades.** These commenters assert that such contracts, **which this proposal does not address**, consume liquidity and damage the price discovery function of the market.” Fed. Reg. 7,5740 Footnote 483.

⁵² Please *see* Better Markets Comment Letter “Aggregation of Positions”(Feb. 10, 2014), *available at* <http://www.bettermarkets.com/sites/default/files/CFTC-%20CL-%20Aggregation-%202-10-14.pdf>

intermediation and liquidity provisions to bona fide hedgers through the swaps market. Further, it's rational to look through traditional back-to-back swaps transactions to account for the ultimate counterparty, and avoid inappropriately penalizing swap dealers for providing hedges to commercial dealers.

However, the Commission's inexplicable use of exemptive authority to undermine the important effect of this provision is indefensible and must be removed.⁵³ In the Supplementary Information to the Proposed Rule, the Commission explains:

"The Commission is proposing to use its exemptive authority under section 4a(a)(7) of the Act to net positions in futures, futures options, economically equivalent swaps and direct-access linked FBOT contracts in the same referenced contract for purposes of single month and all-months-combined limits under proposed § 150.2, discussed below. Thus, a pass-through swap exemption would not be necessary for a swap portfolio in referenced contracts that would automatically be netted with futures and futures options in the same referenced contract outside of the spot month under the Proposed Rule."

Effectively, the Proposed Rule allows swap dealers to net their swaps and offsetting futures contracts such that none of the trades for index swaps and the futures that offset them to masquerade as a *bona fide* hedge, despite the lack of any relevant commercial exposure by either counterparty. Indeed, they are the opposite of a *bona fide* hedge.

The class aggregation structure proposed in vacated part 151 made intuitive sense and enhanced that rule's capacity to implement the goals of the law. One of Congress' four primary objectives of this rule is to ensure sufficient price discovery for *bona fide* hedgers. While multiple aspects of the current commodity derivatives markets must be altered to meet this objective, it is crucial that the price discovery function of the futures market is protected above and beyond the swaps and options market.

The primary benefit to the aggregation by class structure contained in the Vacated Position Limits rule was the effective cap on the large and destructive speculative flows caused CITs. As discussed above, swap dealers intermediate between the funds (through a total return swap) and the futures market (by maintaining a basket portfolio hedge) to streamline exposure for institutional investors. Despite the fact that this index activity is distinct from any commercial exposure, swap dealers were historically granted risk management exemptions from position limits on the positions arising from their index facilitation.

⁵³ USC 6a(a)(7) The Commission, by rule, regulation, or order, may exempt, conditionally or unconditionally, any person or class of persons, any swap or class of swaps, any contract of sale of a commodity for future delivery or class of such contracts, any option or class of options, or any transaction or class of transactions from any requirement it may establish under this section with respect to position limits.

Swap dealers were inappropriate recipients of the risk management exemptions, as their swap risk derived from financial exposure as opposed to commercial exposure. The removal of the risk management exemptions for non-commercial products is appropriate and consistent with the Dodd-Frank Amendments to the CEA.⁵⁴ In particular, Better Markets applauds the Commission for its straightforward language in the Preamble to the Proposed Rule:

“Financial products are not substitutes for positions taken or to be taken in a physical marketing channel. Thus, the offset of financial risks arising from financial products is inconsistent with the proposed definition of bona fide hedging for physical commodities.”⁵⁵

Indeed, the fundamental objective of position limits is to reduce and limit speculative activity that is unrelated to hedging of physical commodities. Swap dealers, financial derivative transactions, and purely speculative market participants should be universally subject to strict, comprehensive limits.

Position Limits Are Too High To Prevent Excessive Speculation

As has been noted, even in a market where producers and consumers are constantly mismatched, the level of speculation required to provide liquidity would never exceed 50% of the market (the level at which each and every trade between producers and consumers is intermediated by a speculator). In a more realistic market, the optimal level of speculation will be considerably lower, and this is borne out by the fact that traditionally speculation has hovered between 15% and 30% of market share (measured in open interest).

If the Rule is to diminish the excessive speculation that is currently damaging the commodity markets, it must therefore ensure that position limits are set at a level that will restore this historical balance. The CFTC is in a uniquely privileged position with respect to the data necessary to make such a calculation, but in similar instances the Commission has at least presented aggregated data and findings for public comment.⁵⁶

Nevertheless, it is possible to draw some general conclusions about the impact position limits would have if implemented at the levels suggested in the Proposed Rule. The individual month limits and all months combined limits approach 2.5% of open interest. These are effectively the same inflated limits that have been in place for legacy commodity contracts for years, ever since the long-standing previous position limits regime was gradually eroded in the 1990s and 2000s.

⁵⁴ § 150.3(f)

⁵⁵ Fed. Reg. 75,740.

⁵⁶ For instance, in the Swap Entity Definition Rule, data was presented to give commenters a sense of how many entities would be affected by setting the various classification criteria at different levels. A similar analysis in the case of position limits would be of great benefit, and is well within the Commission’s capabilities to produce.

Yet within the past few years, numerous violations of even these bloated limits have been documented. Large investment banks like Citi,⁵⁷ JP Morgan,⁵⁸ foreign banks like ANZ⁵⁹ and UBS,⁶⁰ as well as Merrill Lynch Commodities,⁶¹ futures commission merchants like Newedge,⁶² proprietary trading firms like Sheenson Investments,⁶³ and even individuals like James Masterson⁶⁴ have all been fined for violating position limits in commodity markets since the passage of Dodd-Frank required the CFTC to clamp down on excessive speculation. In a single week, over \$2 million of fines were assessed for traders exceeding position limits in cotton alone.⁶⁵

What this demonstrates is that there are at any given time a large number of speculators operating very close to the position limit threshold, if not exceeding them. Yet if position limits are set as high as 2.5% of open interest, this means just twelve non-commercial traders would need to be active in a market to take the percentage of speculative activity to the historical high 30% level. More than twelve speculators could easily drive the level of speculation far above that level, which is the upper range of the historical and arguably optimum level.

In NYMEX Natural Gas alone, there were at least fifty-seven speculators active in just the managed money and other reportables sections of the Commitments of Traders as of January 28, plus at least twenty-seven swap dealers.⁶⁶ In CBOT Wheat, there were at least 183 speculators and at least eighteen swap dealers.⁶⁷ Even if just 10% of these non-commercial participants in the wheat market were to trade close to the proposed position limit, they would be easily sufficient to make the market open interest majority speculative, i.e., speculative market participants would exceed 50% of the entire market.

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- ⁵⁷ See Alper, Alexandra, "Citi to pay penalty for position limits violation: CFTC" (Sep. 21, 2012), available at <http://www.reuters.com/article/2012/09/21/us-cftc-citigroup-idUSBRE88K16320120921>.
- ⁵⁸ See CFTC Press Release "CFTC Orders JP Morgan Chase Bank, N.A. to Pay \$600,000 Civil Monetary Penalty for Violating Cotton Futures Speculative Position Limits" (Sept. 27, 2012), available at <http://www.cftc.gov/PressRoom/PressReleases/pr6369-12>.
- ⁵⁹ See "ANZ cops US fine for 'excessive speculation'" (Sept. 28, 2012), available at <http://www.smh.com.au/business/banking-and-finance/anz-cops-us-fine-for-excessive-speculation-20120928-26pdo.html>.
- ⁶⁰ See Weinberger, Evan, "CFTC Fines UBS Over Position Limits On Energy Futures" (Feb. 25, 2010), available at <http://www.law360.com/articles/151764/cftc-fines-ubs-over-position-limits-on-energy-futures>.
- ⁶¹ See Warner, Melodie, "CFTC Fines Merrill Lynch Commodities \$350,000 For Exceeding Position Limits" (Dec. 7, 2011), available at <http://online.wsj.com/article/BT-CO-20111207-710223.html>.
- ⁶² See Press Release "CFTC fines Newedge for exceeding position limits" (Feb. 7, 2011), available at <http://www.futuresmag.com/2011/02/07/cftc-fines-newedge-for-exceeding-position-limits>.
- ⁶³ See "ANZ cops US fine for 'excessive speculation'" (Sept. 28, 2012), available at <http://www.smh.com.au/business/banking-and-finance/anz-cops-us-fine-for-excessive-speculation-20120928-26pdo.html>.
- ⁶⁴ See Wilson, Jeff, "CME Fines Speculator \$15,000 for Violating Position Limit Rules" (Feb. 4, 2011), available at <http://www.bloomberg.com/news/2011-02-04/cme-fines-speculator-15-000-for-violating-position-limit-rules.html>.
- ⁶⁵ See Perez, Marvin, "U.S. Regulators Fines on Cotton Trading Limits Top \$2 Million" (Sept. 28, 2012), available at <http://www.businessweek.com/news/2012-09-28/u-dot-s-dot-regulators-fines-on-cotton-trading-limits-tops-2-million>.
- ⁶⁶ See "Disaggregated Commitments of Traders- Options and Futures Combined Positions as of February 4, 2014 Reportable Positions" available at http://www.cftc.gov/dea/options/nat_gas_sof.htm.
- ⁶⁷ See "Disaggregated Commitments of Traders- Options and Futures Combined Positions as of February 4, 2014 Reportable Positions" available at http://www.cftc.gov/dea/options/ag_sof.htm.

To avoid this damaging outcome, it is essential that limits be set at a level aimed to maintain no more than 30% speculation in each commodity, and tightened or loosened on a 6-monthly basis depending on the actual level of speculation observed in the market. Basing position limits on an arbitrary percentage of open interest like 2.5% is counter to Congressional intent, and is subject to a perverse feedback loop where increased speculative open interest begets higher limits on speculation. The Commission must therefore take the more direct approach and derive individual limits from the overall proportion of open interest permitted to speculators.

Moreover, as proposed, the Rule contains the paradoxical unintended consequence that exempted speculators (as CITs currently are under the proposal) are still counted towards the open interest base from which position limits for other speculators are calculated. Thus, the large portion of the open interest resulting from CITs, which are not subject to the limits, would have the potential to drive up the total open interest to an unlimited degree. This empowers commodity index investment to effectively raise the position limits for all other speculative positions.

This is clearly an inequitable and nonsensical outcome. Of course, as we and others have shown, the rule must be changed so that CITs are subject to position limits. However, insofar as any group of speculators is exempted from position limits, their positions must not be included in the open interest base used for calculating limits set for all other speculators.

One final observation makes it abundantly clear that the proposed limits are far too high. Commodity exchanges are able to set their own limits to curb speculative trading, yet have an incentive to make these internal limits as high as is sustainable, since their primary source of revenue is fees collected on trades. This is why the CFTC is required to set maximum levels for position limits, because the incentives of for-profit exchanges ensure they will never set them low enough to curb excessive speculation on their own. Despite this fact, **the major exchanges already set limits at levels significantly lower than those proposed in the Rule.**⁶⁸ This is the clearest evidence of all that the Commission's proposed limits are absurdly high, will have no beneficial effect, will not achieve the statutory mandate and will, in all likelihood, make things worse while pretending to make things better.

Conditional Spot Limit Must be Removed

There is no justification for treating cash and physically-settled contracts differently in any month, and settlement characteristics should not be a determinant of the ability to exceed the limits in any month.⁶⁹ The rationale behind including conditional spot limits, which allow a trader with only cash-settled contracts to hold five times the limit, is yet another instance of

⁶⁸ "... the Commission notes that DCMs historically have set or maintained exchange spot month limits at levels below 25 percent of deliverable supply. Setting such a lower level of a spot month limit may also serve the objectives of preventing excessive speculation, manipulation, squeezes and corners, while ensuring sufficient market liquidity for bona fide hedgers in the view of the listing DCM and ensuring the price discovery function of the market is not disrupted. Hence, the Commission observes that there may be a range of spot month limits, including limits set at levels below 25 percent of deliverable supply, which may serve as practicable to maximize these policy objectives." Release at 75,729.

⁶⁹ Proposed Rule § 150.3(c) (c) "Conditional spot-month limit exemption. The position limits set forth in § 150.2 may be exceeded for cash- settled referenced contracts provided that such positions do not exceed five times the level of the spot-month limit specified by the Commission and the person holding or controlling such positions does not hold or control positions in spot-month physical-delivery referenced contracts."

the Commission inappropriately crafting rules that target manipulation instead of the broader category of excessive speculation.

In the preamble, the Commission explains:

“... the condition of the exemption—i.e., a trader availing himself of the exemption may not have any position in the physical-delivery contract—reduces the ability for a trader with a large cash- settled contract position to attempt to manipulate the physical-delivery contract price in order to benefit his position. As such, the conditional spot- month limit exemption would further three of the goals under CEA section 4a(a)(3)—detering market manipulation, and ensuring sufficient market liquidity for bona fide hedgers, without disrupting the price discovery”⁷⁰

First, as demonstrated above, cash-settled contracts can disrupt the price discovery function provided by the futures market. Traders dealing in exclusively cash-settled contracts wield enormous influence on physical prices, both by shaping market expectations of future supply and demand, and directly determining physical transaction prices through contractual convention. Allowing outsized concentration of speculative positions in cash-settled markets may independently disrupt price discovery.

Additionally the Proposed Rule **does not** prohibit speculators in cash-settled contracts from owning an unlimited position in the cash commodity underlying the contract.⁷¹ Vacated Part 151.4 restricted the cash commodity holdings of a speculator availing the conditional spot limit to 25% of deliverable supply. The Proposed Rule has replaced this common sense restriction in favor of basic reporting requirements for simultaneous cash holding.

This means that a trader may own up to 125% of deliverable supply in cash settled contracts, while simultaneously purchasing up to 100% of deliverable stocks. Not only does this present an obvious opportunity to manipulate prices, the CFTC itself has filed manipulation charges against a firm employing precisely this strategy as recently as 2011.⁷²

Conditional spot limits consist of a departure from the statutory mandate to deter excessive speculation and unjustly allow outsized position concentration in certain contract-types over others. Conditional Spot Limits must be removed, and all settlement-types should be treated equally in relation to the position limits that govern them.

⁷⁰ Release at 75,771.

⁷¹ “As proposed, this broad conditional spot month limit exemption for cash- settled contracts would be similar to the conditional spot month limit for cash- settled contracts in proposed § 151.4. However, unlike proposed § 151.4, proposed § 150.3(c) would not require a trader to hold physical commodity inventory of less than or equal to 25 percent of the estimated deliverable supply in order to qualify for the conditional spot month limit exemption.” Release at 75,737.

⁷² See CFTC Press Release “CFTC Charges Parnon Energy Inc., Arcadia Petroleum Ltd. And Arcadia Energy (Suisse) SA with Price Manipulation in the Crude Oil Market” (May 24, 2011), available at <http://www.cftc.gov/PressRoom/PressReleases/pr6041-11>.

Limits Must Be Reset More Frequently than Every 2 Years

According to the Proposed Rule, the spot month, non-spot month and all-months-combined position limits will be updated no less frequently than every 2 calendar years. Biennial updates to limits are completely inadequate, and the frequency must be reconsidered.⁷³

The CFTC is in the midst of a major overhaul of its data regime, and the capacity to record, analyze, and quickly react to market data has never been greater and continues to expand. The vast data the Dodd-Frank Act requires the CFTC to collect from derivatives clearing organizations, swap data repositories, and exchanges will for the first time allow the Commission to make adjustments to regulatory measures almost on demand. There can be no doubt that Congress intended for the regulators to use this new data, or it would not have been required in the statute. The fact that, under the proposal, the Commission looks set to make only minimal use of the available data therefore poses serious questions as to whether the Rule adequately implements Congress' clear intent.

In fact, the clear trend of market measurement across market data providers is higher frequency temporal data. Thus in this case it seems the CFTC is going in the opposite direction. When the Part 151 Position Limits rules were proposed in 2011, the proposed compliance frequency was yearly. This low frequency was criticized by end-user groups and hedgers for being far too infrequent to adequately account for market changes. Vacated Part 151, however, valued the input of swap dealers and their trade groups over that of commercial hedgers and followed the industry recommendation to further reduce the frequency from yearly to every two years.

Unfortunately, as market conditions change, and position limits set earlier become outdated, they can easily become a "safe harbor" for trading activity. Thus, updating position limits more frequently will also have significant benefits to the marketplace. Position limit changes will more accurately reflect current market conditions and more precisely serve the regulatory purposes underlying the position limits rules.

The rules should be designed in such a way that they encourage market participants to monitor their own open interest to maintain compliance. Regular updates of position limits will motivate traders to implement stringent monitoring and procedures to adjust their activities to remain in compliance.

CONCLUSION

The Dodd-Frank Act Requires the imposition of new position limits that will effectively combat excessive speculation. While the Proposed Rules address manipulation, the problem of excessive speculation is not addressed in clear violation of the law. We have articulated the serious need to expand the scope of the rule on position limits by demonstrating the effects of excessive speculation, and in particular speculation by commodity index funds, on commodity prices. We have pointed out the specific adverse impact that excessive speculation has on price discovery. We have documented the relationship of CIT speculation on market liquidity. And we have laid out a regime for setting and enforcing limits on excessive speculation.

⁷³ 150.2(e)(3).

In summary, the Proposed Rule must be changed to include the following:

- Specifically include CITs in the definition of reference contract;
- Reinstate aggregation by class, and apply pass-through exemption to disaggregated positions;
- Lower position limits to a level that will combat both excessive speculation *and* manipulation;
- Remove the conditional spot month limit; and
- Increase the frequency of position limit reviews and compliance from every 2 years to at least every 6 months.

We hope that this comment letter aids the CFTC in its effort to address this important rule making.

Sincerely,



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