Occupy the SEC

http://www.occupythesec.org

August 7, 2014

Melissa Jurgens
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, DC 20581

Re: Position Limits and Aggregation Proposals (RIN 3038-AD99 and RIN 3038-AD82)

Dear Madam:

Occupy the SEC ("OSEC")[1] is pleased that the Commodity Futures Trading Commission ("CFTC"; "Agency") reopened its comment period on derivative position limits. We commend the Commission's decision to push this reform, which is required not only under the Dodd-Frank Act[2] but moreover in light of increasing market concentration in the commodities arena. We share with leading advocates and academics the view that strict position limits are necessary to ensure against manipulative and speculative practices that have caused abrupt changes in the price and supply of vital natural resources.

I. INTRODUCTION

The Dodd Frank reforms required the Commission to exercise its long-standing authority to impose position limits to restrain price speculation in commodities trading where such speculation poses an "undue and unnecessary burden on interstate commerce in such commodity."[3] The law requires that the Agency regulate manipulation and speculation, ensure liquidity for bona fide hedgers, and prevent disruption to the price-discovery function of the underlying market.[4] Congress intended these modest restrictions to ensure that prices reflect market fundamentals and that resource allocation benefits the ultimate consumers and producers.

[1] Occupy the SEC (http://occupythesec.org) is a group of concerned citizens, activists, and financial professionals that works to ensure that financial regulators protect the interests of the public, not Wall Street.
[2] The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).
[3] Commodities Exchange Act ("CEA"), 7 U.S.C. § 6a(a)(1)–(2).
[4] CEA, 7 U.S.C. 6a(a)(3).

Indeed, the United States is not alone is recognizing the need for position limits in the commodities industry, as the European Union has espoused similar restrictions with the recent promulgation of the Markets in Financial Instruments Directive (MiFID) II.

As the market concentration of institutions trading derivatives and their underlying commodities has increased during the post-financial crisis period, the threat that these institutions pose to the efficient functioning of commodities and financial markets at large has concomitantly accelerated.[5] Several firms trade both physical commodities and related derivatives, and therefore play an anomalous role in shaping the markets. The increasing market position of a handful of firms inhibits the price-discovery function of commodities contracts. As largely non-commercial traders take substantial positions, derivative prices diverge from market fundamentals in a volatile manner that often results in resource misallocation.[6]

As Better Markets has argued, speculative activity that exceeds 30% of open interest in a commodity market actually reduces overall liquidity and distorts market function.[7] Admittedly, some speculation can facilitate the efficient functioning of commodity derivative markets and enable transactions between parties. Orthodox economic theory posits and significant evidence shows, however, that oligopolistic firms that trade on outsized derivative and commercial positions may manipulate prices and supply in both markets as they acquire inside market information.

Robust commodities position limits also provide broader, secondary benefits to financial markets and public welfare. First, such limits promote prudent **risk management** by regulated firms (which is a statutory objective of the Commission).[8] Indeed, the collapse of Amaranth Advisors, LLC in 2006 following gross overinvestment in the natural gas markets exemplified the dangers of poor risk management. Moreover, the availability and price stability of commodities such as wheat have broader implications on economic efficiency, public welfare, and political security that transcend the markets at issue.

We therefore urge that the Commission define any exceptions to position limits in a conservative manner. We commend the CFTC's efforts to employ the tool of aggregation in determining market positions. The Agency should strengthen these safeguards by imposing position limits on all instruments, including **Commodities Index Trading (CITs) and cash-settled commodity contracts**. It should also impose spot-month and other monthly limits according to instrument and by the percentage of the market that constituted speculative trading, as opposed to just limiting the percentage of trading that an individual entity conducts in the marketplace.

II. HEDGING

We also counsel against the CFTC authorizing broad hedging exemptions to the position limits regime. As many commentators have argued, oftentimes derivatives have been exaggeratedly described as highly effective devices for hedging risk. In truth, many

---

[5] Tatyana Shumsky & Sarah Kent, *Commodity Traders Take Center Stage*, Wall St. J., July 10, 2014; Saule T. Omarova, *Merchants of Wall Street: Banking, Commerce, & Commodities*, 98 Minn. L. Rev. 265, 297-98 (2013).
[6] Studies show that such resource misallocation contributes to boom-bust cycles, as well as frequent occurrences of *contango* and disruption of the role of futures markets in setting prices.
[7] Comment Letter of Better Markets Regarding Position Limits (Feb. 10, 2014), *available at* http://www.bettermarkets.com/sites/default/files/CFTC-%20CL-%20Position%20Limits-%202-10-14-%20Final.pdf.
[8] *See* 7 U.S.C. § 12a(7)(D)(ii).

sophisticated end users have succumbed to monumental losses from failed "hedging" instruments crafted by "innovative" financial institutions.[9]

A. The Limited Utility of Hedging as a Risk Mitigation Strategy

Hedging can have some utility, especially for commercial enterprises and end-users. However, and quite unfortunately, the increasing presence of speculation in the commodities market hinders the effectiveness of hedging against market fluctuations.

Speculation tends to drive prices in artificial, exogenous ways that can have little to do with the actual supply and demand of an underlying commodity. As speculation becomes more significant, one's ability to effectively hedge against price fluctuations decreases. Speculation-driven momentum can dry up counterparty positions, rendering hedging a practically difficult task. In such an environment, not even the largest firms with enormous balance sheets and portfolios can be sure to effectively hedge their positions.

Indeed, hedges at one point in time may no longer remain reliable hedges down the road. For instance, during times of crisis, commodities prices can begin to track each other. Moreover, many products can be manipulated such that they artificially assume a reasonable correlation with a reference asset based on purely technical, rather than fundamental factors. A common practice in illiquid markets, for instance, is for traders to adopt some unrelated but comparatively cheap asset as a "hedge" for their products. With enough sponsorship, such a proxy hedge can abandon its own fundamentals and adopt the technical qualities of the asset that it is meant to hedge. In times of stress, this artificial correlation can break down quickly and turn a hedged position into two naked exposures.

We recognize that an exemption for bona fide hedging has a basis in the statute but we contend that the CFTC must closely examine the hedging, or insurance, function in which a firm engages. In today's commodities market, hedging is at best an imperfect tool for risk mitigation. Further, speculative positions can easily be disguised as "hedging," particularly in the case of anticipatory hedging. We therefore urge that the Agency allow exceptions in a limited and justified manner, ex-ante, and not through ad-hoc exemptions. Alternatively, it should greatly constrict the scope of the categories of hedging that are permitted in the Proposed Rules.

B. The Cross-Commodity Hedging Exception is Fraught With Risk

Cross-commodity hedges are, by definition, imperfect hedges because of the presence of basis risk. Basis risk is generally understood as the risk that two assets move inconsistently with each other. By condoning the expanded usage of cross-commodity hedges, the Proposed Rules will actually inject greater risk into the system. Market participants may be unduly sanguine about the safety of their positions, expecting their cross-commodity hedges to completely absolve them of risk (despite the glaring presence of basis risk).

Cross-commodity hedging also infuses greater complexity into the recordkeeping (and auditing) process. Since a cross-commodity hedge will be an imperfect substitute for an initial position, a bona fide hedger would need to make multiple "hedges" to account for the initial exposure. The complicated risk profiles of derivative products require a variety of piecemeal

---

[9] *See* Wallace Turbeville, *Toward an Understanding of the Use of Derivatives by End Users*, included in AN UNFINISHED MISSION: MAKING WALL STREET WORK FOR US (Americans for Financial Reform & Roosevelt Institute Report) (2013).

trades to hedge each component risk, and each of these hedges presents new exposures that also require hedging. As a result, the trading books of such products quickly become a complicated web of inter-dependent trades that are increasingly difficult to adequately unwind. The best way to avoid this needless complexity is to disallow cross-commodity hedging altogether, on the basis that this mechanism does not necessarily "reduce[] risks attendant to a position" and is not generally "economically appropriate to the reduction of risks."[10]

In the alternative, we recommend that the Commission modify the "five day rule" so that a cross-hedging position cannot be coupled with a position in a physical-delivery contract during the **greater of** the last five days of trading or the time period for the spot month in such physical-delivery contract. The current proposal uses an unsatisfactory "lesser of" formulation, which could easily lead to unanticipated fluctuations in the actual supply of the physically settled commodity beyond the five-day window from the settlement date.

C. The Anticipatory Hedging Exception is Likewise Fraught With Risk

The anticipatory hedging exemption is excessively broad because it allows traders to hedge not only against future risks facing assets currently owned, produced, manufactured, processed or merchandised, but also to hedge against assets which a person anticipates owning, producing, manufacturing, processing, or merchandising. This overly broad exemption could permit a firm to feign interest in acquiring assets for the purposes of justifying its positions. Any "hedge" made on an anticipatory basis is unlikely to be a perfect substitute for a firm's actual exposure in the physical markets. Market conditions can shift dramatically, and hedges taken without a present basis in reality are *de facto* risky investments. Like the Cross-Commodity Hedging exception, the Anticipatory Hedging exception should be eliminated for running afoul of the Dodd-Frank Act's Section 737.[11]

D. The Hedging Exclusions Need More Specific Regulatory Delineation

The stated hedging exceptions must be clearly limited and defined to prevent distortion of market fundamentals. We are concerned that the current hedging exemptions under the position limits regime feature vague definitions and are inordinately subject to the self-definition of DCMs and SEFs. The Proposed Rules permit DCMs and SEFs to define what is recognized as a bona fide hedging position. This creates an added layer of complexity to the rulemaking that could engender more ambiguous language. A broad definition of hedging may unduly benefit large market players who employ the strategy to engage in speculative financial activity rather than as legitimate insurance against commodity pricing changes.

The CFTC has already faced great difficulty in implementing its position limits regime. The timeline for effective implementation will only increase if the drafting of significant market rules is passed off to DCMs and SEFs. Moreover, it is not clear that such market rules would be open to public comment to the same extent as definitions promulgated by the CFTC. Thus, such delegation may run afoul of the Administrative Procedure Act. Lastly, this element of the rulemaking would likely create an environment conducive to producing a "race to the bottom" among DCMs and SEFs as they would have incentives to attract and retain participants seeking to take advantage of the loosest rules.

---

[10] 7 U.S.C. § 6a(c)(2).
[11] *Id*.

E. Recordkeeping for Participants Seeking Exemptions

The CFTC cannot merely rely on regulated firms to characterize their trading strategies as hedging. If given the opportunity, such firms will cut every possible corner to engage in ineffective-yet-cheap "hedges" that maximize profits in the near term. The Commission should therefore employ clear external guidelines in defining exceptions to the position limits rules. It should also require frequent and detailed disclosure of trading data to ensure compliance. Proposed Rule 17 CFR 150.3(h) requires any person claiming a position limit exemption to maintain records and to provide such information to the Commission "upon call." This approach is too passive. Market participants claiming exemptions will be required to maintain books and records on an ongoing basis. The Commission should also require such participants to provide the Commission with such information on a periodic and automatic basis. We recognize that the Commission has a limited staff and budget, and may not have the resources to review every submission. Even so, participants seeking an exemption should nonetheless provide complete books and records on a frequent, periodic basis so that Commission examiners have detailed historical data to analyze during their compliance audits. This more frequent reporting requirement should not be considered to be burdensome at all, given that required records are likely kept in electronic format, and further given that market participants availing of position limit exceptions would be required to maintain such records whether they are periodically submitted to the Commission (as we suggest) or not.

III. AGGREGATION

A. Aggregation: Ownership Interests of Greater Than 50 Percent in An Owned Entity

The Proposed Rules contain a novel exemption from the aggregation requirement, for certain ownership interests of greater than 50 percent in an owned entity, that is plainly useless. The over 50 percent requirement builds on restrictions built into the 10 percent to 50 percent exemption, and adds a veritable gauntlet of conditions that few companies will be able to pass. For instance, the proposal requires several indicia of separation or absence of control to be shown before the Commission will grant the exemption for ownership interests of greater than 50 percent in an owned entity. The Commission, already resource-strapped, is creating unnecessary work for itself by crafting this convoluted exemption and thereby requiring itself to review applications seeking this exemption. Even Commissioner O'Malia, a staunch friend of industry, has questioned the necessity of the over 50 percent exception because few (if any) companies would meet its requirements. In general, OSEC supports the promulgation of simple and effective *per se* regulations that are both transparent and useful in regulating market conduct. The 50 percent aggregation exception is not such a regulation. The current Aggregation Proposal already contains numerous other exemptions that can be utilized by truly distinct market participants whose positions should not be aggregated.

Moreover, even if the exception could be utilized by a significant number of companies, it should still be removed because it would be harmful to the markets at large. As noted above, speculation above fairly low limits only leads to distortions in market function. The historical

evidence, on which the Agency itself relies, shows that there can be no plausible justification for exempting largely interconnected firms from the position limits regime.

B. Aggregation Based on Substantially Identical Trading Strategies

Section 737 of the Dodd-Frank Act requires aggregation of positions where two or more persons trade pursuant to an expressed or implied agreement or understanding to execute a common trading strategy.[12] The statute leaves open the question of exactly how such aggregation is to be monitored or computed. The CFTC, in Proposed Rule 150.4(b) seems to require market participants to self-report any common trading strategies. Needless to say, such participants may be reluctant to fully report collusive strategies. To address this problem, we encourage the CFTC to require DCMs and SEFs to analyze market data for correlations in trading strategies between market participants. Aggregation can be executed automatically at the DCM/SEF level based on the outcome of such correlation analysis.

Another section of the CEA, 7 U.S.C. 6a(a)(6), mandate that the Commission "shall" place position limits on aggregated positions of "any group or class of traders." This section envisions aggregation on a broad scale, even if a class of traders does not have an explicit or implied agreement to trade in common. The Commission should heed this mandate by applying position limits to a large number of actors acting in concert, whether or not such concerted activity is by design. After all, concerted speculative activity can have the same deleterious effect on the markets irrespective of the each individual actor's intent.

As Better Markets and others have argued, the Commission should aggregate the positions of Commodity Index Traders (CITs), a class of traders that pose special risk to normal market functions. CIT investments operate outside of the normal operation of the commodity markets, as they are price-invariant and do not reflect commodity market movements. Rather, CITs sway market prices due to sheer volume and for exogenous, non-market reasons. Aggregating the positions of CITs for purposes of position limits would lead to a significant reduction in market speculation, and would facilitate the predictable operation of commodities markets.

IV. SPOT LIMITS

A. Setting of Limits in Physical-Delivery and Cash-Settled Contracts in Spot Versus Non-Spot Months

We recognize that the Proposed Rules specify separate limits for cash-settled versus physically-settled contracts during the spot month. The Commission is correct to exhibit solicitude about supply constraints in the physical commodity markets, especially in the spot month. However, the fact is that corners and other supply fluctuations can occur during non-spot months as well. As the Proposed Rules recognize, cash-settled and physically-settled contracts feature different risks. For example, physically settled contract can cause fluctuations in the actual supply of commodities, while cash-settled contracts can be subject to enhanced speculative activity because they are detached from actual supplies and do not generally contribute to price discovery. Indeed, we would argue that there is no reason to treat cash-settled contracts as uniformly less dangerous than physically-settled contracts. The simple fact is that

[12] Codified at 7 U.S.C. § 6a(a)(1).

each settlement type poses unique risks to markets and efficient capital distribution. Accordingly, different position limits should apply to each settlement type, with an eye towards addressing the particular risk profile of that type. Thus, cash and physical contracts should not be netted, whether in the spot-month or other months. Such netting only serves to conflate fundamentally different product classes and mask important differences between them.

B. The Conditional Spot-Month Limit Exemption: a Recipe for Oligopoly

The Proposed Rules establish position limits that are already too high. To make matters worse, they permit a trader to hold up to five times the normal spot-month position limit for cash-settled derivatives. The Commission attempts to justify this significant concession to industry by noting that cash-settled contracts (unlike their physically-settled counterparts) do not generally lead to supply fluctuations in the spot month. Nevertheless, the proposed 5x spot-limit still unduly threatens the cash markets with an influx of speculative activity.

In its proposal, the Commission argues that the proposed conditional exemption is benign because it would, at most, permit a speculator to own positions in cash-settled referenced contracts equivalent to no more than 125% of the estimated deliverable supply. This argument is flawed for two reasons. First, 125% of the estimated deliverable supply of a commodity is an incredibly high "limit" for any market participant. Second, the 25% spot restriction on deliverable supply would not apply until the future. In the interim, DCM-set spot-month limits would apply.

The conditional limit condones the acquisition of gargantuan positions by relatively few market participants, which could result in inefficient market concentration and oligopolistic conditions. With a few large players dominating the cash-delivery market, there would be fewer investment (and hedging) opportunities for commercial end users. Such an oligopoly in the commodities markets would reduce liquidity, a stated objective of the position limits statutory regime.

The Commission itself recognizes that this exemption for cash-settled derivatives could enable market manipulation, but attempts to downplay this risk by claiming that it could squash market manipulation through monitoring. As Americans for Financial Reform (AFR) point out in their comment letter, this claim is untenable given the Commission's resource limitations. Additionally, the Commission cannot depend on monitoring being consistently effective because the agency could be subject to a myriad of distractions including the inevitable political struggles over priorities that go with staff turnover. The very fact that it has taken an excessively long period of time to implement the position limits rule should stand as evidence that employing an effective monitoring strategy will not be viable. We encourage the Commission to consider how it can minimize its operational latency through the greater utilization of strict, *per se* rules. Otherwise, it would not be unreasonable to assume that the Final Rule will, despite all the careful consideration taken to draft the rule, lack teeth.

C. The Setting of Non-Spot Limits on Wheat Contracts

We commend the somewhat more restrictive limitations that the CFTC has imposed on wheat trading. These limits apply to both cash-settled contracts and physically delivered contracts. Significant recent Congressional and academic studies reinforce the contention that prices in the wheat market exhibit a boom-and-bust cycle and diverge significantly from market

fundamentals. As futures prices reflect a speculative boom, often displaying contango despite the perishable nature of the good, there are heightened prices. The likely over-allocation of resources toward crop development consequently carries the possibility of a speculative bust. On both the consumer and producer side of the ledger, the resultant price and supply instability negatively impacts public welfare. Effective position limits can help deter such a boom-bust cycle in the wheat market.

V. CONCLUSION

As the Agency asserts in the Proposed Rules, it is required to act in light of a clear Congressional mandate and evidence of serious market distortion. We urge it to act in a decisive and aggressive manner in furtherance of this mandate, and place little credence on self-interested industry exhortations for looser regulation.

Thank you.

Sincerely,
/s/
Occupy the SEC

Neil
Akshat Tewary
Eric Taylor
et al