Position Limits

A Brief History and Discussion of Recent Regulatory Changes

Managed Funds Association

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Position Limits

Executive Summary:

This presentation provides a brief history of position limits in the U.S., how the limits work, as well as an update on recent legislative and regulatory activity.

The imposition of position limits has always been a highly political and contentious issue. In the early 20th century, U.S. federal regulators first imposed limitations on the quantity of certain agricultural contracts a person may trade for speculative purposes. Using its authority under the Dodd-Frank Act of 2010, one federal regulator has expanded position limits to cover non-agricultural commodities, such as energy and metals, and even certain swaps.

The European Union is reviewing position limits in its review of the Markets in Financial Instruments Directive and Regulation, which are expected to be completed by early 2013.

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How Do the Futures Markets Work?

The futures markets were created as a means for farmers (sellers) to hedge against the risk of commodity prices in the future by entering into a futures contract. It also provides the opportunity for buyers of commodities to limit their risk. For example, a farmer growing potatoes would want to ensure that he got a minimum price for his crop. Similarly, a potato chip manufacturer would want to limit the cost of potatoes. They both use the futures markets to hedge their respective risks. A successful futures market needs both hedgers and speculators.

Speculators (and dealers) buy and sell futures contracts hoping to make a profit on changing prices but also exposing themselves to loss. In our example, there is no certainty that the farmer and the potato chip maker will “meet” at exactly the same time in the futures markets. Speculators and dealers buy and sell futures contracts constantly, providing market liquidity. Without speculators and dealers, it is very unlikely that a hedger, such as a farmer, will be able to relay or transfer price risk.

What Are Position Limits?

A position limit is a limitation on the number of contracts with respect to a particular commodity that a person is allowed to own. In general, regulators only establish position limits with respect to speculative trading.

Regulators use position limits as a tool to reduce the potential threat of market manipulation or congestion; to reduce the potential of price distortions, such as “excess speculation”; and to mitigate clearinghouse credit risk.

Position Limits: A Brief History

The Federal government first imposed speculative position limits in 1917 and 1921 as famers and others blamed speculators for the continued depression in grain prices after World War I. On the other side of the debate—grain merchants, the grain exchanges and others in the grain industry believed that the setting of position limits was not only unnecessary but would be harmful to the trade.

In 1936, after fierce debate that had raged since the Great Depression over tumbling farm prices, Congress amended the Commodity Exchange Act to set limits on trading "as the commission finds is necessary to diminish, eliminate, or prevent" excessive speculation. In 1938, the Commodity Exchange Commission (CEC) – the predecessor to the Commodity Futures Trading Commission (CFTC) – implemented position limits in wheat, corn, oats, barley, flaxseed, grain sorghums, and rye.

For many agricultural commodities, the CEC never established any speculative position limits, such as butter, wool tops, livestock, and livestock products. When the Chicago Mercantile Exchange (CME) began trading pork belly futures, live cattle futures, and live hog futures, acting under its own authority, it established speculative trading limits for trading in those contracts.

Source: CFTC - http://www.cftc.gov/PressRoom/SpeechesTestimony/berkovitzstatement072809 ,

The Debate on Position Limits

The issue of position limits has always engendered contentious debate. On one side of the debate, farmers, end-users, and others have blamed excessive speculation for depressed agricultural commodity prices. Similarly, during periods of high energy prices, some have demanded the implementation of position limits to reduce high prices. In 2008, the spike in oil prices renewed the debate on the implementation of position limits, except this time proponents blamed speculators for raising prices excessively rather than depressing prices.

On the other side of the debate, opponents have argued that high/low prices have been a result of supply and demand fundamentals; position limits have not reduced price volatility or prevented market manipulation; and that position limits could impair the operation of markets and the ability of commercial market participants/hedgers to use the futures markets to hedge against rising prices.

"Speculators" in the Marketplace

Hedge Funds Provide a "Buffer" Against Market Volatility:

Academic and government studies have not found excessive speculation to be the cause of recent market volatility and show that policies restricting investor access to derivatives markets impair commercial participants' ability to hedge and restrict the use of risk management tools.

In fact, the CFTC's own Interagency Task Force on Commodity Markets examined crude oil market pricing in July 2008, and determined the following:

*"The Task Force has found that the activity of market participants often described as "speculators" has not resulted in systematic changes in price over the last five and a half years. On the contrary, most speculative traders typically alter their positions following price changes, suggesting that they are responding to new information – just as one would expect in an efficiently operating market. In particular, the positions of hedge funds appear to have moved inversely with the preceding price changes, suggesting instead that their positions might have provided a buffer against volatility-inducing shocks."**

*Interim Report on Crude Oil. CFTC.gov. July 2008.

Position Limits: The CFTC

The CFTC was created in 1974 as an independent regulatory agency to regulate all commodity futures and options contracts and markets in the U.S.*

Since its founding, the CFTC has maintained federal speculative position limits on previously-limited agricultural commodities. These are listed in CFTC regulation 150.2.

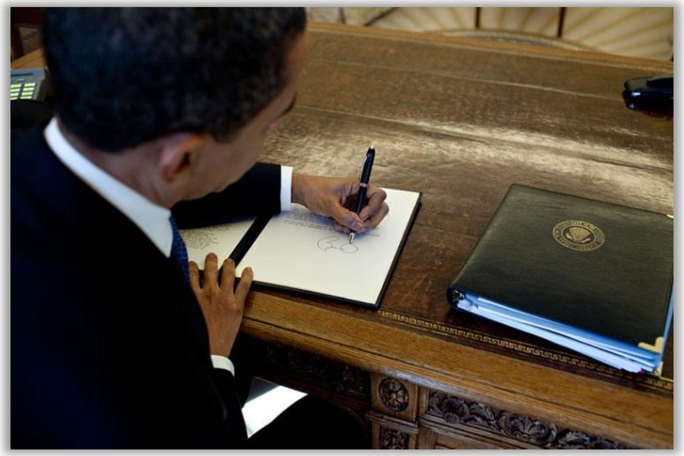
In 1981, the CFTC required exchanges to set speculative position limits for all commodities not subject to federal limits.**

Sources: *CFTC – http://cftc.gov/About/MissionResponsibilities/index.htm **CFTC - http://www.cftc.gov/PressRoom/SpeechesTestimony/berkovitzstatement072809

Position Limits and Dodd-Frank

Establishing New Limits:

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). Title VII of the Dodd-Frank Act amended the Commodity Exchange Act ("CEA") to establish a comprehensive new regulatory framework for swaps and security-based swaps.



Section 737 of the Dodd-Frank Act requires the CFTC to establish limits on the amount of positions, as appropriate, that may be held by any person with respect to contracts traded on a designated contract market; and to set aggregate position limits based upon the same underlying commodity, including certain OTC derivatives contracts and contracts traded on a foreign board of trade.

The Commission proposed and ultimately adopted final rules in part 151 regarding position limits for 28 physical commodity futures and option contracts ("Core Referenced Futures Contracts") and their economically equivalent swaps.

Position Limits: The CFTC

The CFTC's Regulatory Framework for Position Limits:

The CFTC generally imposes stricter speculative limits in physical delivery markets during the "spot month," or the month when the futures contract matures and becomes deliverable. The Commission believes it is important to have strict limits during the spot month because physical delivery may be necessary. As a result, the commodity may be more vulnerable to price fluctuation caused by irregularly large positions or unusual trading practices.

The CFTC does not impose limits in markets under low or non-existent threat of manipulation, such as major foreign currency markets.

Sources: *CFTC – http://cftc.gov/About/MissionResponsibilities/index.htm **CFTC - http://www.cftc.gov/IndustryOversight/MarketSurveillance/SpeculativeLimits/index.htm

Position Limits: The CFTC

The CFTC's Regulatory Framework for Position Limits:

The CFTC considers three elements in setting the regulatory framework for speculative position limits**:

1. The size, or levels, of the limits.

2. Exemptions from the limits.

3. Whether and which accounts should be combined (aggregated) in applying the limits.

Sources: *CFTC – http://cftc.gov/About/MissionResponsibilities/index.htm **CFTC - http://www.cftc.gov/IndustryOversight/MarketSurveillance/SpeculativeLimits/index.htm

How Position Limits Work

The Different Types of Position Limits Imposed by the CFTC:

In setting position limits, regulators set spot month and non-spot month limits. On October 18, 2011, the CFTC adopted new spot month and non-spot month standards which set forth the following limitations:

- **Spot month limit** – Also called "Current Delivery Month," spot-month refers to the month when a futures contract matures and becomes deliverable. Generally, spot month limits are set at 25% of estimated deliverable supply of the commodity.

- **Non-spot month limit** - These limits apply to positions in all contract months combined or in a single contract month. CFTC limits are set at 10 percent of open interest in the first 25,000 contracts and 2.5 percent thereafter. The CFTC sets these limits by Commission order using industry data.

Position Limits and Exchanges

Twenty-Eight Physical Commodities Are Limited Across the Following Exchanges:

CBOT

The Chicago Board of Trade

- CBOT Corn (C)
- CBOT Oats (O)
- CBOT Soybeans (S)
- CBOT Soybean Meal (SM)
- CBOT Soybean Oil (BO)
- CBOT Wheat (W)
- CBOT Rough Rice

cme

Chicago Mercantile Exchange

- CME Class III Milk (DA)
- CME Feeder Cattle (FC)
- CME Lean Hog (LH)
- CME Live Cattle (LC)

ice Global markets in clear view

- ICE Futures U.S. Cotton No. 2 (CT)
- ICE Futures U.S. Cocoa (CC)
- ICE Futures U.S. Coffee C (KC)
- ICE Futures U.S. FCOJ-A (OJ)
- ICE Futures U.S. Sugar No. 11 (SB)
- ICE Futures U.S. Sugar No. 16 (SF)

KANSAS CITY BOARD OF TRADE

- Hard Winter Wheat (KW)

Position Limits and Exchanges

Limited Physical Commodities:

New York Mercantile Exchange

- NYMEX Henry Hub Natural Gas (NG)
- NYMEX Light Sweet Crude Oil (CL)
- NYMEX New York Harbor Gasoline Blendstock (RB)
- NYMEX New York Harbor Heating Oil (HO)
- NYMEX Palladium (PA)
- NYMEX Platinum (PL)

Commodity Exchange Inc. (COMEX)

- COMEX Copper (HG)
- COMEX Gold (GC)
- COMEX Silver (SI)

MGEX

- Hard Red Spring Wheat (MWE)

*MGEX – Minneapolis Grain Exchange

CFTC Rulemaking - Aggregation

What is the CFTC's New Aggregation Proposal?

One of the major components of the CFTC's final rulemaking on position limits governs how individuals must aggregate, or combine, their accounts and holdings to determine compliance with the established limits.

<u>Details on the CFTC's new aggregation proposal:</u>

- Any person owning less than 10 percent equity interest in another entity/account is not required to aggregate their positions, absent common control.
- Any person owning an equity interest between 10 and 50 percent may disaggregate their positions if they can demonstrate independence of trading.
- Aggregation is required if one entity owns greater than 50 percent of another entity.
- The CFTC proposes to permit individuals to not have to aggregate positions if they meet certain criteria related to the location of trading, risk management systems, use of different traders, and restrictions on information sharing across entities.

MFA Advocacy

MFA believes that:

- Futures markets must perform their fundamental price discovery, risk transfer and risk management functions, which depend on the existence of liquid, fair, and competitive markets.
- If the CFTC imposes position limits, it must be cognizant of the effect of the federal limits on the ability of markets to function.
- Any limits set should be based on empirical data. Otherwise, inappropriate limits may impair the ability of market participants to use the derivatives markets to hedge risk.
- If the CFTC believes that it must set position limits, it should only set position limits once it has reliable data on the size and traits of each market.
- Entities that share common ownership but are independently operated should not have to aggregate their positions. This would cover commonly owned entities that share certain employees who do not control trading decisions.

Read our recent comment letter to the CFTC to learn more about MFA's advocacy on position limits and aggregation.

References

U.S. Regulatory Agencies:

Commodity Futures Trading Commission
www.cftc.gov

March 28, 2011 - MFA Comment Letter to the CFTC

April 11, 2011 – MFA Comment Letter to the CFTC

June 28, 2012 - MFA Comment Letter to the CFTC

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