Securities Regulation Daily Wrap Up, TOP STORY—CFTC re-proposes rules on position limits, (Nov. 5, 2013)

By Lene Powell, J.D.

The CFTC voted to propose rules that would establish limits on speculative positions in 28 physical commodity futures contracts, as well as swaps that are economically equivalent to those contracts. The goal of the proposed rules is to prevent excessive speculation and manipulation, while ensuring there is enough market liquidity for *bona fide* hedgers and protecting the price discovery process. The vote was 3 to 1, with Commissioner Scott O'Malia dissenting.

"What we have here is a very well-researched and buttoned-down rule," said Chairman Gary Gensler.

The proposed rulemaking is the agency's second attempt in the area of position limits. The D.C. District Court vacated the first set of rules in September 2012, because the CFTC had not addressed a statutory ambiguity about whether the agency was required to first find that the rules were necessary. The CFTC appealed the decision, but said it would drop the appeal upon re-proposing the rules.

The new rulemaking is divided into two proposals. The first proposal contains the position levels and exemptions, and the second proposal makes a staff recommendation on aggregation standards.

Proposed position limit regime. The proposed rules would set speculative position limits for 28 core physical commodity futures contracts and economically equivalent swap contracts, including nine commodities currently subject to limits. Of the 28 commodities, four are energy, five are metals, and 19 are agricultural. The rules would be implemented in phases to ease administrative burdens.

According to staff member Steve Sherrod, the CFTC will later propose to expand future reference contracts to include all physical commodities. CFTC staff has described 464 separate contracts that would be reference contracts under the proposal.

The proposed rules set two types of speculative limits: spot-month position limits and non-spot-month position limits. Spot-month position limits apply in the period immediately before delivery obligations are incurred for physical-delivery contracts, or a period immediately before contracts are liquidated by the clearinghouse based on a reference price for cash-settled contracts.

Generally, spot-month position limits for referenced contracts will be set at 25% of estimated deliverable supply. The limits will be applied separately for positions in the physical-delivery and all cash-settled referenced contracts combined.

The non-spot-month position limits apply to positions a trader has in all contract months combined or in a single contract month. For each referenced contract, these limits will be set at 10 percent of open interest in the first 25,000 contracts and 2.5 percent thereafter. Initial non-spot-month position limits will be set based on open interest data in futures and swaps that are significant price discovery contracts. Subsequent levels will be reset at least every two years based on open interest data in futures, cleared swaps, and uncleared swaps.

"Economically equivalent" swap contracts. The rules provide that a swap contract may be economically equivalent to a futures contract when:

(1) it is a "look-alike" contract (*i.e.*, it settles off of the core referenced futures contract or contracts that are based on the same commodity for the same delivery location as the core referenced futures contract);

(2) it is a contract with a reference price based on only the combination of at least one referenced contract price and one or more prices in the same or substantially the same commodity as that underlying the relevant core referenced futures contract, provided that such a contract is not a locational basis swap;

(3) it is an intercommodity spread contract with two reference price components, one or both of which are based on referenced contracts; or

(4) it is priced at a fixed differential to a core referenced futures contract.

Proposal addresses ambiguity in statute. In vacating the initial position limits rules, the court said the CFTC mistakenly took the position that Congress mandated the agency to set position limits and stripped it of all discretion not to impose limits. The CFTC argued that it was not required to find that position limits were necessary or appropriate before imposing them, because Congress mandated the imposition of speculative limits. The court rejected this interpretation and found that that section of the Dodd-Frank Act was ambiguous as to whether a finding of necessity and appropriateness was required. Because the CFTC failed to address the Dodd-Frank Act's ambiguity, the court remanded the rule to the agency.

Regarding the re-proposed rules, Sherrod said the proposal contains a legal analysis of the statutory requirements. The CFTC brought its "expertise and experience" to bear on resolving the statutory ambiguity, and concluded that Congress decided position limits were necessary for physical commodities.

Staff member Lee Ann Duff said that the staff made a finding of necessity out of "an abundance of caution." The staff found that the proposed limits were necessary as a " prophylactic measure" to lessen the likelihood that a trader will accumulate speculative positions that could cause unwarranted price fluctuations, which can happen even without manipulative conduct.

Market impact of speculation. Chairman Gensler said that the staff reviewed 130 studies on the impact of speculation, noting that there was not a consensus. In fact, two different parts of the Federal Reserve came out on different sides of the question, with the St. Louis bank finding that there was no link between speculation and price, and the Dallas bank concluding that a link could not be determined.

Staff member Hannah Ropp said that about one-third of the studies found a link between speculation and prices, one-third found no link, and one-third were inconclusive. Chairman Gensler said that was a classic "jump ball" situation; and because there were dire consequences if the studies that found a link were right, it was better to err on the side of caution. Sherrod noted that the staff was not legally required to consider the studies to set position limits. However, if there were no congressional

mandate and the staff had to use discretion to determine whether position limits were needed, then it would be appropriate to look at the studies and err on the side of caution.

Commissioner Bart Chilton said he had personally reviewed many of the studies and decided that there is a link between speculation and price changes. In 2008, when supply and demand were about even, the price of crude oil shot from $90 to almost $150 per barrel, then fell to $30, he said. Commissioner Chilton explained that people want the speculation question to be black and white; they want to know if speculators drove *all* of the price changes. However, that is not the right question. If speculators drove *some* of the price changes, that is a concern for the agency, said Commissioner Chilton.

Commissioner O'Malia asked how the rulemaking walks the narrow line to diminish the speculative concerns while enhancing hedging activity. Sherrod replied that the limits are set at high levels to avoid interfering with the market's price discovery function. For example, the staff recommended that the existing limit level for wheat on the Board of Trade be retained. Currently, the limit level is set at 180 million tons of wheat. The spot-month limit is 4000 semi-trucks full of wheat and the single-month limit is 20 times the spot-month limit. Sherrod explained that the staff erred on the high side in setting the levels, and there should be adequate liquidity.

The vote on the first proposal was 3 to 1, with Chairman Gensler and Commissioners Chilton and Mark Wetjen in support and Commissioner O'Malia dissenting.

Aggregation. The second proposal addressed aggregation standards. Chairman Gensler explained that aggregation is important because market participants trade through many legal entities. For example, when Lehman Brothers failed, it had 3,300 legal entities within its corporate family. Chairman Gensler questioned whether a limit should be imposed on the 3,300 entities individually or as a whole. He reasoned that if the same corporation controls the entities, then it is necessary to aggregate positions. Otherwise, Chairman Gensler said, it is just an end-run around the position limits.

Chairman Gensler added that although he supported the amendments, which would permit four additional exemptions from aggregation, it was important not to loosen aggregations to the extent that suddenly the Lehman Brothers's 3,300 companies would have all been separated. Aggregation under position limits is critical if the position-limits regime is to have any meaning, the chairman said.

The CFTC unanimously adopted the staff's recommendation on aggregation standards and exemptions.

O'Malia dissent. In a prepared dissent, Commissioner O'Malia questioned whether the agency had "done its homework" on the re-proposal. He said the CFTC should have taken more time to analyze the new data, especially from the swaps market, that has been collected under the Dodd-Frank Act. Commissioner O'Malia found it was especially troubling that almost two full years after large trader entities began reporting data under Part 20 of CFTC regulations, the data being reported is still unreliable and unsuitable for setting position limit levels. , That the agency is forced to resort to using data from 2011 and 2012 as a poor and inexact substitute, said Commissioner O'Malia.

The CME Group also objected to the proposed rules, saying that although it supports position limits rules, the proposed rules are neither warranted nor necessary, particularly outside of the spot months. CME Group is especially concerned about proposed conditional limits, which would allow a trader to hold up to five times the limit in a cash-settled version of a contract. Conditional limits could increase the potential for price dislocation, said CME Group, especially in the final days of trading. Furthermore, CME Group argued that conditional limits could damage the price discovery that occurs when a futures contract converges with the physical market as it gets closer to delivery.

Chilton announces departure. Commissioner Chilton said he sent a letter to President Obama this morning to announce his resignation in the "not too distant future."

The CFTC currently has four commissioners, three Democrats and one Republican. Some reports expect Chairman Gensler, a Democrat, to depart at the end of the year.

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