Public Statements & Remarks

Statement of Commissioner Dawn D. Stump Regarding Final Rule: Position Limits for Derivatives

October 15, 2020

Overview

With all that has transpired in our country and in our lives this year, it feels like ages ago that we gathered together in person to consider proposing amendments to update the Commission's rules regarding position limits back at the end of January. At the time, I said that there were three guideposts by which I would evaluate that proposal: First, is it reasonable in design? Second, is it balanced in approach? And third, is it workable in practice for both market participants and for the Commission?

Since I believed the answer to each of these questions was yes, I supported issuing the proposal. And by and large, my belief has been confirmed by the comments we received from those who trade in this country's derivatives markets. In the months since January, we have heard from all corners of the marketplace–agricultural interests, energy interests, managed fund advisors, and dealers that provide liquidity, to name a few–that have voiced support for the fundamental architecture of the position limits framework that we proposed. Their support stands in stark contrast to the serious concerns they had expressed about the several previous position limit proposals put forward by the Commission during the past decade.

Of course, each interest had its issues with one aspect or another in the proposal. That is to be expected, given the varied and sometimes divergent objectives for our position limit rules set out in the Commodity Exchange Act (CEA).[1] Congress has tasked us with adopting position limits that: 1) on the one hand, diminish, eliminate or prevent excessive speculation in derivatives and deter and prevent market manipulation, squeezes, and corners; while on the other hand, and simultaneously 2) ensuring sufficient market liquidity for bona fide hedgers and ensuring that the price discovery function of the underlying market is not disrupted and does not shift to foreign competitors.

Reasonable minds will always differ as to exactly where to draw the line among these statutory objectives. But while we must always strive for perfection, we cannot permit that aspiration to paralyze us from acting to improve our rule sets. The final position limit rules before us smooth some of the rough edges in the proposal, and they address the areas in which I expressed some misgivings at the time. They incorporate valuable input we have received from the exchanges that operate the markets and the businesses that trade in those markets.

And above all, the final rulemaking is reasonable in design, balanced in approach, and workable in practice. For these reasons, I am pleased to support it.

Bona Fide Hedging and Spread Transactions: Policy and Process

In commenting on the proposal in January, I noted two areas that I felt could be improved: 1) the list of enumerated bona fide hedging transactions and positions; and 2) the process for reviewing hedging transactions outside of that list. I want to briefly address each of these concerns, in turn.

Enumerated Bona Fide Hedges

The CEA prohibits the Commission from adopting position limit rules that apply to bona fide hedging transactions or positions, as such terms are defined by the Commission. It gives the Commission the authority to define the term "bona fide hedging transactions and positions" to "permit producers, purchasers, sellers, middlemen, and users of a commodity or a product derived therefrom to hedge their legitimate anticipated business needs . . ."[2] Congress thereby recognized the critical function of our derivatives markets in enabling those whom we all depend upon to deliver goods and services to hedge their risks–both risks they currently bear as well as those they reasonably anticipate.[3]

The Commission's proposal recognized this as well, as it expanded the list of "enumerated" bona fide hedging transactions that are identified in our current rules. Positions taken as a result of these enumerated hedging transactions constitute bona fide hedging, and therefore are not subject to federal speculative position limits. This expansion of the list of enumerated bona fide hedges is entirely appropriate (indeed, it is long overdue). Hedging practices at companies that produce, process, trade, and use agricultural, energy, and metals commodities have become far more sophisticated, complex, and global over time, and the Commission's list of enumerated hedging practices to which its position limit rules do not apply has failed to keep pace with these realities.

And given Congress' recognition of the appropriateness of hedging legitimate anticipated business needs,[4] the proposal also added, at my request, anticipatory merchandising as an enumerated bona fide hedge. There is no policy basis for distinguishing hedging risks of anticipated merchandising from hedging risks of other activities in the physical supply chain.

Yet, I was concerned in January that our proposed list of enumerated bona fide hedges still might not be as robust as it should be. We needed input on this question from market participants–especially those in the energy and metals sectors where we are applying federal position limits for the first time. And that input was nearly unanimous in recommending that hedging the risk of unfixed-price forward transactions be added to the list of enumerated bona fide hedges.

Hedges of offsetting unfixed-price cash commodity sales and purchases have historically been recognized as an enumerated bona fide hedge under our rules, and that was carried over in the proposal, too. These are hedges of risk incurred where a market participant has both bought and sold the underlying cash commodity at unfixed prices. We received many comments, though, urging us to include as an enumerated bona fide hedge those situations in which the purchase or sale, but not both, is an unfixed-price forward transaction. Some commenters asked that the historical enumerated hedge for offsetting unfixed-price cash commodity sales and purchases be expanded to cover unfixed-price cash commodity sales or purchases; others asked the Commission to create a new, stand-alone enumerated bona fide hedge category for these unfixed-price transactions. The final rulemaking concludes that neither step is necessary because, as suggested by still other commenters, commercial market participants may qualify for one of the enumerated anticipatory bona fide hedges that will be available, to the extent of their demonstrated anticipated need.[5]

Spread Transactions

Although the treatment of spread transactions for purposes of federal position limits is distinct from the treatment of bona fide hedging transactions, I would like to take a short detour to note an important similarity between the two. That is, we also received numerous comments suggesting that the proposed definition of a spread transaction, which would be exempt from federal position limits, was too narrow.

At the suggestion of commenters, the final rulemaking adds the well-established categories of intra-market, inter-market, and intra-commodity spreads to the list of defined spreads that fall outside the federal position limits regime. The release notes that as a result, the spread transaction definition captures most, if not all, spread exemptions currently granted by exchanges and used by market participants. The rulemaking appropriately recognizes that these spread positions simply do not raise the type of concerns that position limits are intended to address.

The Non-Enumerated Bona Fide Hedge Recognition Process

Getting the list of enumerated bona fide hedges right is important because they are “self-effectuating” for purposes of federal position limits. In other words, a trader need not count positions that result from enumerated bona fide hedging transactions towards the federal position limits, and does not need to apply to the Commission for approval (although the trader still must receive approval from the relevant exchange to exceed exchange-set limits).

Other hedging practices, generally referred to as “non-enumerated” hedges, can still be recognized as bona fide hedging, but only after a review process. A trader can either ask the exchange and the Commission to separately review and approve the proposed non-enumerated hedging activity for purposes of exchange and federal limits, respectively, or it can follow what the rulemaking calls a “streamlined” process. Under that process, if an exchange recognizes a non-enumerated transaction as a bona fide hedge for purposes of the exchange’s position limits, the Commission would then review the exchange’s bona fide hedge recognition for application to federal limits as well. The Commission must notify the exchange and market participant of any denial within 10 business days, or 2 business days in the case of an application based on a sudden or unforeseen increase in the trader’s bona fide hedging needs (although that timeline can be extended if the Commission issues a stay or requests additional information).

In January, I expressed reservations about whether this 10/2-day process would be workable in practice for either market participants or the Commission because it appeared to be both too long and too short: 1) too long to be workable for market participants that may need to take a hedge position quickly; and 2) too short for the Commission to meaningfully review the relevant circumstances related to the exchange's recognition of the hedge as bona fide. But while some commenters took the "too long" view and others took the "too short" view, the majority of commenters were generally supportive of this process.

The final rulemaking adopts the 10/2-day process, with an adjustment recommended by several commenters as well as participants in a meeting of the Commission's Energy and Environmental Markets Advisory Committee (EEMAC)[6] that discussed the position limits proposal. That is, the final rulemaking now provides that a trader can exceed federal limits based on the exchange's approval of the non-enumerated hedge while the Commission is conducting its assessment. This is not a delegation of authority to the exchange, since the Commission will still make the final determination whether positions resulting from the non-enumerated hedging transaction should count towards federal position limits. Thus, a trader that exceeds federal limits in reliance on the initial exchange determination runs the risk that the Commission will later deny the requested non-enumerated hedge. In that event, the trader will have to reduce the position to come into compliance with limits within a commercially reasonable period of time.

Is it a perfect process? It is not. My preference would have been that recognition of non-enumerated hedges be the responsibility of the exchanges, which are most familiar with both their own markets and the hedging practices of participants in those markets. The Commission, in turn, has the tools it needs to monitor this process through its routine, ongoing review of the exchanges. But those who participate in the markets have generally expressed the view that this is a reasonable, balanced, and workable process. And so, I support it.

Response to Commenter Objections

Before concluding, I would like to briefly respond to a couple of points raised by commenters that were critical of the proposed position limit rules. Some commenters argued that: 1) the amendments to the CEA's position limit provisions that were enacted as part of the Dodd-Frank Act[7] constitute a mandate for the Commission to establish federal position limits without having to make an antecedent finding that such limits are necessary to achieve the CEA's objectives; and 2) the rules we are adopting improperly abdicate Commission responsibilities with respect to federal position limits to the exchanges.

The Commission's Mandate to Impose Position Limits it Finds are Necessary

As I read the statute, the CEA's position limit provisions, as amended by the Dodd-Frank Act, mandate the Commission to impose position limits that it finds are necessary. The basis for my view is set out in detail in my statement in support of the proposal last January, which included an explanatory graphic. Both of these documents are available on the Commission's website for those who are interested,[8] and so I will not repeat that analysis here. Suffice it to say, though, that I have not seen anything in the comment letters we received that changes my view.

The Role of the Exchanges

I fundamentally disagree with the suggestion that the amended position limit rules that we are adopting in any way reflect an inappropriate reliance by the Commission on the exchanges. My disagreement is rooted in several considerations.

First, the CEA itself states without limitation that it is the purpose of the CEA to serve the public interests described in the statute "through a system of effective self-regulation of trading facilities, clearing systems, market participants and market professionals under the oversight of the Commission."[9] This is an overarching statement of purpose by Congress, and is the lens through which all other provisions of the CEA–including its position limit provisions–must be interpreted. And nothing in the amendments to those position limit provisions enacted as part of the Dodd-Frank Act indicate otherwise.

Second, the rules we are adopting do not delegate any authority of the Commission to the exchanges. With respect to applications for non-enumerated bona fide hedges in particular, the Commission will be informed by an exchange's determination whether to recognize the hedge for purposes of exchange-set limits. But the determination whether to do so with respect to federal limits is the Commission's alone to make, and a trader who trades in reliance on an exchange determination risks having to reduce the position if the Commission subsequently disagrees with the exchange's determination.

Third, the exchanges know their markets.[10] They have a comprehensive understanding of the traders that participate in those markets as well as current hedging practices in agricultural, energy, and metals commodities. Indeed, the expertise of the exchanges makes them uniquely well-suited to make the initial determination on requests for non-enumerated bona fide hedges in real-time.

Finally, I return once again to my foundational principles: Reasonable, balanced, and workable. A system in which a business must put its economic needs and risk management efforts on hold while the Commission undertakes to learn about its operations and hedging activities in order to pass upon a request for a non-enumerated bona fide hedge violates all three principles.

Conclusion

After nearly a decade of trying, we stand on the cusp of amending the Commission's position limit rules, which are sorely in need of updating. Before us is a thorough and well-reasoned final rulemaking release that considers the extensive comments we received, and clearly presents the Commission's rationale in addressing those comments and adopting the rules in the form that we are adopting them. The fact that this release is before us less than nine months after we issued the proposal–in the midst of a pandemic, no less–is a tribute to the dedication, perseverance, and analytical capabilities of the professionals in the Commission's Division of Market Oversight, Office of General Counsel, and Chief Economist's Office. Their work on this rulemaking has been nothing short of amazing.

My fellow Commissioners and I have each publicly committed that we would work to finish a position limits rulemaking. The time has come to fulfill that commitment. The release that staff has presented is reasonable in design, balanced in approach, and workable for both market participants and the Commission. I am pleased to support it.

[1] CEA Section 4a(a), 7 U.S.C. § 6a(a).

[2] CEA Section 4a(c)(1), 7 U.S.C. § 6a(c)(1).

[3] The CEA provides that a bona fide hedging transaction or position is one that, among other things, "is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise." CEA Section 4a(c)(2)(A)(ii), 7 U.S.C. § 6a(c)(2)(A)(ii). The Commission's policy in administering federal position limits in the agricultural sector over the years has been to limit this economically appropriate test to the hedging of price risk. However, as set forth in the final rulemaking release, the Commission acknowledges, consistent with that historical policy, that price risk can be impacted by various non-price risks.

[4] CEA Section 4a(c)(1), 7 U.S.C. § 6a(c)(1). *See also* CEA Section 4a(c)(2)(A)(iii)(I), 7 U.S.C. § 6a(c)(2)(A)(iii)(I) (bona fide hedging transaction or position is a transaction or position that, among other things, "arises from the potential change in the value of . . . assets that a person owns, produces, manufactures, processes, or merchandises or *anticipates* owning, producing, manufacturing, processing, or merchandising . . ." (emphasis added)).

[5] These enumerated anticipatory bona fide hedges include: 1) the existing enumerated bona fide hedge for unsold anticipated production; 2) the existing enumerated bona fide hedge for anticipated requirements; and 3) the new enumerated bona fide hedge established in this rulemaking for anticipated merchandising.

[6] *See, e.g.,* Transcript of CFTC Energy and Environmental Markets Advisory Committee Meeting at 103:14-17, Comment by Thomas LaSala, CME Group (May 7, 2020) ("the Commission should permit a participant to exceed Federal position limits during the 10-day/2-day Commission review period of an exchange-granted exemption"), *available at* https://www.cftc.gov/sites/default/files/2020/06/1591218221/eemactranscript050720.pdf.

[7] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203 (2010) ("Dodd-Frank Act").

[8] *See* Statement of Commissioner Dawn D. Stump Regarding Proposed Rule: Position Limits for Derivatives (January 30, 2020), and Commodity Exchange Act § 4a(a): Finding Position Limits Necessary is a Prerequisite to the Mandate for Establishing Such (January 30, 2020), *available at* https://www.cftc.gov/PressRoom/SpeechesTestimony/stumpstatement013020.

[9] CEA Section 3(b), 7 U.S.C. § 5(b).

[10] It is notable that, due to certain trading dynamics unique to natural gas contracts, including the existence of liquid cash-settled contracts trading on three different exchanges, the final rulemaking for the federal conditional spot-month limit is derived from the existing exchange framework that has been in place for approximately a decade.

-CFTC-