Public Statements & Remarks

Supporting Statement of Commissioner Brian Quintenz Regarding Position Limits for Derivatives

October 15, 2020

I am pleased to support the agency's revitalized approach to position limits. The rulemaking finalized today follows four proposals since the passage of the Dodd-Frank Act[1]and is, by far, the strongest of them all. I commend Chairman Tarbert for his leadership in completing this rulemaking. I am very pleased that today's final rule echoes the key policy points I outlined in my remarks before the 2018 Commodity Markets Council State of the Industry Conference.[2] The new position limits regime will provide commercial market participants with sufficient flexibility to hedge their risks efficiently and will promote liquidity and price discovery.

Today's rule promotes flexibility, certainty, and market integrity for end-users–farmers, ranchers, energy producers, transporters, processors, manufacturers, merchandisers, and all who use physically-settled derivatives to risk manage their exposure to physical goods. The rule includes an expansive list of enumerated and self-effectuating bona fide hedge exemptions and spread exemptions, and a streamlined, exchange-centered process to adjudicate non-enumerated bona fide hedge exemption requests. I am pleased that the rule seriously considered the usability of hedging exemptions, and I thank Commissioner Stump for her leadership on that point.

In contrast to the Commission's failed proposed rulemakings in 2011, 2013, and 2016, this rule is the most true to the CEA in many significant respects. It requires, as has long been the Commission's practice, a necessity finding before imposing limits. It includes economically equivalent swaps. And, perhaps most importantly, it balances the interests among promoting liquidity, deterring manipulation, and ensuring the price discovery function of the underlying market is not disrupted.[3] The confluence of these factors occurs most acutely in the spot month for physically-settled contracts. In the spot month, price convergence is exceptionally vulnerable to potential manipulation or disruption due to outsized positions. By establishing position limits for non-legacy contracts only in the spot month, the rule elegantly balances the countervailing policy interests enumerated in the statute.

Responding to the Public's Concerns

Through staff's serious consideration of over 70 public comments, the final rule significantly improves on what appears in the proposal. Examples of modifications based on public comment include considerations of gross hedging, price risk, the pass-through swap exemption, spot month limits for natural gas and cotton, a special non-spot single-month limit for cotton, spread exemptions, and the Commission's review of exchange-granted non-enumerated hedge exemptions.

With regard to enumerated bona fide hedges, the final rule took into account several suggestions from commenters. The proposed enumerated hedges were already a significant improvement upon previously proposed hedge exemptions (for example, eliminating a mandatory "five-day rule"[4] and no longer conditioning cross-commodity hedging on a needlessly rigid quantitative test). Now, under the final rule, the enumerated hedges will be even more practical. For example, the final rule makes clear that a hedger with only an unfixed-price cash commodity sale or purchase, but not an offsetting pair, may rely on one of the three anticipatory hedges, provided that the other elements of such hedge are also met, even though the hedger is ineligible to elect the hedge for a pair of unfixed-price sale and purchase transactions.[5] The final rule also makes clear that the new anticipatory merchandising hedge can be used both by integrated energy firms and by firms that limit their business to merchandising. Furthermore, the final rule permits the anticipatory merchandising hedge to now be used in connection with storage hedges.

I support the final rule's determination to delay by two years two important elements that will require significant changes in the marketplace: the imposition of position limits on swaps economically equivalent to the referenced futures contracts and the required unwinding of previously elected risk management exemptions.[6] It is prudent to allow for additional time for financial entities to adjust to these significant new policies.

Necessity Finding

Today's rule correctly premises new limits on a finding that they are necessary to diminish, eliminate, or prevent the burden on interstate commerce from extraordinary price movements caused by excessive speculation (necessity finding) in specific contracts, as Congress has long required in the CEA and its legislative precursors since 1936.[7] I am pleased that the rule complies with the District Court's ruling in the ISDA-position limits litigation: that the Commission must decide whether Section 4a of the CEA mandates the CFTC set new limits or only permits the CFTC to set such limits pursuant to a necessity finding.[8] As the District Court noted, "the Dodd-Frank amendments do not constitute a clear and unambiguous mandate to set position limits."[9] I agree with the rule's determination that, when read together, paragraphs (1) and (2) of Section 4a demand a necessity finding.

Section 4a(a)(2)(A) states that the Commission shall establish limits "in accordance with the standards set forth in paragraph (1) of this subsection."[10] Paragraph (1) establishes the Commission's authority to, "proclaim and fix such limits on the amounts of trading… as the Commission finds are necessary to diminish, eliminate or prevent [the] burden" on interstate commerce caused by unreasonable or unwarranted price moves associated with excessive speculation. This language dates back almost verbatim to legislation passed in 1936, in which Congress directed the CFTC's precursor to make a necessity finding before imposing position limits. The Congressional report accompanying the CEA from the 74th Congress includes the following directive, "[Section 4a of the CEA] gives the Commodity Exchange Commission the power, after due notice and opportunity for hearing and a finding of a burden on interstate commerce caused by such speculation, to fix and proclaim limits on futures trading ..."[11] In its ISDA opinion, the District Court noted the following: "This text clearly indicated that Congress intended for the CFTC to make a 'finding of a burden on interstate commerce caused by such speculation' prior to enacting position limits."[12]

I support the rule's view that the most natural reading of Section 4a(a)(2)(A)'s reference to paragraph (1)'s "standards" is that it logically includes the "necessity" standard. Paragraph (1)'s requirement to make a necessity finding, along with the aggregation requirement, provide substantive guidance to the Commission about when and how position limits should be implemented.

If Congress intended to mandate that the Commission impose position limits on all physical commodity derivatives, there is little reason it would have referred to paragraph (1) and the Commission's long established practice of necessity findings. Instead, Congress intended to focus the Commission's attention on whether position limits should be considered for a broader set of contracts than the legacy agricultural contracts, but did not mandate those limits be imposed.

Setting New Limits "As Appropriate"

The rule determines that position limits are necessary to diminish, eliminate, or prevent the burden on interstate commerce posed by unreasonable or unwarranted prices moves that are attributable to excessive speculation in 25 referenced commodity markets that each play a crucial role in the U.S. economy. Conversely, the rule also finds that the contracts on which the referenced limits are placed are the only contracts which met the necessity finding. The rule explicitly states that no other contracts met this test.

I am aware that there is significant skepticism in the marketplace and among academics as to whether position limits are an appropriate tool to guard against extraordinary price movements caused by extraordinarily large position size. Some argue there is no evidence that excessive speculation currently exists in U.S. derivatives markets.[13] Others believe that large and sudden price fluctuations are not caused by hyper-speculation, but rather by market participants' interpretations of basic supply and demand fundamentals.[14] In contrast, still others believe that outsized speculative positions, however defined, may aggravate price volatility, leading to price run-ups or declines that are not fully supported by market fundamentals.[15]

In my opinion, one thing is predominately clear: position limits should not be viewed as a means to counteract long-term directional price moves. The CFTC is not a price setting agency and we should not impede the market from reflecting long term supply and demand fundamentals. A case in point is palladium, the physically-settled contract which has seen the largest sustained price increase recently,[16] and which has also seen its exchange-set position limit decline four times since 2014 to what is now the smallest limit of any contract in the referenced contract set.[17] Nevertheless, between the start of 2018 and the end of 2019, palladium futures prices rose 76%.[18] Taking these conflicting views and facts into account, it is clear the Commission correctly stated in its 2013 proposal, "there is a demonstrable lack of consensus in the [academic] studies" as to the effectiveness of position limits.[19]

With that healthy dose of skepticism, and in strict accordance with the balance of factors which Dodd Frank added to the CEA for the Commission to consider, I think the rule appropriately focuses on the time period and contract type where position limits can have the most positive, and the least negative, impact-the spot month of physically settled contracts-while also calibrating those limits to function as just one of many tools in the Commission's regulatory toolbox that can be used to promote credible, well-functioning derivatives and cash commodity markets.

Because of the significance of these 25 core referenced futures contracts to the underlying cash markets, the level of liquidity in the contracts, as well as the importance of these cash markets to the national economy, I think it is appropriate for the Commission to protect the physical delivery process and promote convergence in these critical commodity markets. Further, the limits issued today are higher than in the past, notably because the rule utilizes current estimates of deliverable supply-numbers which haven't been updated since 1999. [20]

Taking End-Users Into Account

Perhaps more than any other area of the CFTC's regulations, position limits directly affect the participants in America's real economy: farmers, ranchers, energy producers, manufacturers, merchandisers, transporters, and other commercial end-users that use the derivatives market as a risk management tool to support their businesses. I am pleased that today's rule takes into account many of the serious concerns that end-users voiced in response to this rulemaking's proposal, and in response to the CFTC's previous four unsuccessful position limits proposals.

Importantly, and in response to many comments, this rule, for the first time, expands the possibility for enterprise-wide hedging,[21] (including additional clarification provided in the proposal in response to comments), establishes an enumerated anticipated merchandising exemption,[22] eliminates the “five-day rule” for enumerated hedges,[23] and no longer requires the filing of certain cash market information with the Commission that the CFTC can obtain from exchanges.[24] Regarding enterprise-wide hedging–otherwise known as “gross hedging”–the rule will provide an energy company, for example, with increased flexibility to hedge different units of its business separately if those units face different economic realities. The final rule eliminates the requirement that exchanges document their justifications when allowing gross hedging; clarifies that market participants are not required to develop written policies or procedures that set forth when gross versus net hedging is appropriate; and clarifies that gross hedging is permissible for both enumerated and non-enumerated hedges.[25]

With respect to cross-commodity hedging, today’s rule completely rejects the arbitrary, unworkable, ill-informed, and frankly, ludicrous “quantitative test” from the 2013 proposal.[26] That test would have required a correlation of at least 0.80 or greater in the spot markets prices of the two commodities for a time period of at least 36 months in order to qualify as a cross-hedge.[27] Under this test, longstanding hedging practices in the electric power generation and transmission markets would have been prohibited. Today’s rule not only shuns this Government-Knows-Best approach, it also establishes new flexibility for the cross-commodity hedging exemption, allowing it to be used in conjunction with other enumerated hedges, such as hedges of anticipated merchandising transactions.[28] For example, an energy marketer anticipating buying and selling jet fuel to supply airports will be eligible for a hedge exemption in connection with trading heating oil futures, a commonly-used cross-commodity hedge for jet fuel.

Bona Fide Hedges and Coordination with Exchanges

For those market participants who employ non-enumerated bona fide hedging practices in the marketplace, the final rule creates a streamlined, exchange-focused process to approve those requests for purposes of both exchange-set and federal limits. I am pleased that commenters were generally supportive of the proposed process. As the marketplaces for the core referenced futures contracts addressed by the proposal, the DCMs have significant experience in, and responsibility towards, a workable position limits regime. CEA core principles require DCMs and swap execution facilities to set position limits, or position accountability levels, for the contracts that they list in order to reduce the threat of market manipulation.[29] DCMs have long administered position limits in futures contracts for which the CFTC has not set limits, including in certain agricultural, energy, and metals markets. In addition, the exchanges have been strong enforcers of their own rules: during 2018 and 2019, CME Group and ICE Futures US concluded 32 enforcement matters regarding position limits.

As part of their stewardship of their own position limits regimes, DCMs have long granted bona fide hedging exemptions in those markets where there are no federal limits. Today's final rule provides what I believe is a workable framework to utilize exchanges' long standing expertise in granting exemptions that are not enumerated by CFTC rules.[30] This rule also recognizes that the CEA does not provide the Commission with free rein to delegate all of the authorities granted to it under the statute.[31] The Commission itself, through a majority vote of the five Commissioners, retains the ability to reject an exchange-granted non-enumerated hedge request within 10 days of the exchange's approval.[32] The Commission has successfully and responsibly used a similar process for both new contract listings as well as exchange rule filings, and I am pleased to see the final rule expand that approach to non-enumerated hedge exemption requests that will limit the uncertainty for bone fide commercial market participants.

Limits on Swaps

The CEA requires the Commission to consider limits not only on exchange-traded futures and options, but also on "economically equivalent" swaps.[33] Today's final rule provides the market with far greater certainty on the universe of such swaps than the previous proposed rulemakings. Prior proposals failed to sufficiently explain what constituted an "economically equivalent swap," thereby ensuring that compliance with position limits was essentially unworkable, given real-time aggregation requirements and ambiguity over in-scope contracts. In stark contrast, today's rule narrows the scope of "economically equivalent" swaps to those with material contractual specifications, terms, and conditions that are identical to exchange-traded contracts.[34] For example, in order for a swap to be considered "economically equivalent" to a physically-settled core referenced futures contract, that swap would also have to be physically-settled, because settlement type is considered a material contractual term. I believe the narrowly-tailored definition included in today's rule will provide market participants with clarity over those contracts subject to position limits. I think it is prudent that the final rule took commenters' concerns about updating compliance systems into account by delaying for an additional year, beyond the general compliance date of January 1, 2022, that is until January 1, 2023, the imposition of position limits on economically equivalent swaps.

Conclusion

During my confirmation hearing in front of the Senate Committee on Agriculture, Forestry and Nutrition on July 27, 2017, I was asked to directly commit to finalizing a position limits rule. My response was brief, but unquestionable: "Yes, I commit to support finalizing a position limits rule." Making such a commitment to a committee of the U.S. Congress in sworn testimony is something I take very seriously, second only to taking my oath to defend the Constitution of the United States. With today's vote, I am very pleased to have made good on that commitment three years in the making and am even more proud of the product with which I was able to fulfill it.

[1] 76 Fed. Reg. 4,752 (Jan. 26, 2011); 78 Fed. Reg. 75,680 (Dec. 12, 2013); 81 Fed. Reg. 38,458 (June 13, 2016) ("supplemental proposal"); and 81 Fed. Reg. 96,704 (Dec. 30, 2016). The Commodity Exchange Act (CEA) addresses position limits in Section (Sec.) 4a (7 U.S.C. § 6a).

[2] Remarks of Commissioner Brian Quintenz before the CMC State of the Industry 2018 Conference, https://www.cftc.gov/PressRoom/SpeechesTestimony/opaquintenz5

[3] Sec. 4a(a)(3).

[4] Previous versions of enumerated hedges had required a hedger to eliminate positions in excess of position limits during the last five days of the spot month.

[5] Preamble discussion of Exemptions from Federal Position Limits. The hedge for a pair of offsetting unfixed-price transactions is described in Appendix B, paragraph (a)(3), and the anticipatory hedges are described in Appendix B, paragraphs (a)(4) – (6).

[6] Whereas the general compliance date for the final rule is January 1, 2022, the compliance date for these two items is January 1, 2023.

[7] Sec. 4a(1).

[8] ISDA et al. v CFTC, 887 F. Supp. 2d 259, 278 and 283-84 (D.D.C. Sept. 28, 2012).

[9] Id. at 280.

[10] Sec. 4a(a)(2)(A) ("In accordance with the standards set forth in paragraph (1) of this subsection and consistent with the good faith exception cited in subsection (b)(2), with respect to physical commodities other than excluded commodities as defined by the Commission, the Commission shall by rule, regulation, or order establish limits on the amount of positions, as appropriate, other than bona fide hedge positions, that may be held by any person with respect to contracts of sale for future delivery or with respect to options on the contracts or commodities traded on or subject to the rules of a designated contract market.")

[11] H.R. Rep. 74-421, at 5 (1935).

[12] 887 F. Supp. 2d 259, 269 (fn 4).

[13] Testimony of Erik Haas (Director, Market Regulation, ICE Futures U.S.) before the CFTC at 70 (Feb. 26, 2015) ("We point out the makeup of these markets, primarily to show that any regulations aimed at excessive speculation is a solution to a nonexistent problem in these contracts."), *available at*: https://www.cftc.gov/idc/groups/public/@aboutcftc/documents/file/emactranscript022615.pdf.

[14] BAHATTIN BÜYÜKŞAHIN & JEFFREY HARRIS, CFTC, THE ROLE OF SPECULATORS IN THE CRUDE OIL FUTURES MARKET 1, 16-19 (2009) ("Our results suggest that price changes leads the net position and net position changes of speculators and commodity swap dealers, with little or no feedback in the reverse direction. This uni-directional causality suggests that traditional speculators as well as commodity swap dealers are generally trend followers."), *available at* http://www.cftc.gov/idc/groups/public/@swaps/documents/file/plstudy_19_cftc.pdf; Testimony of Philip K. Verleger, Jr. before the CFTC, Aug. 5, 2009 ("The increase in crude prices between 2007 and 2008 was caused by the incompatibility of environmental regulations with the then-current global crude supply. Speculation had nothing to do with the price rise."), *available at:* https://www.cftc.gov/sites/default/files/idc/groups/public/@newsroom/documents/file/hearing080509_verleger.pdf

[15] For a discussion of studies discussing supply and demand fundamentals and the role of speculation, *see* 81 Fed. Reg. 96704, 96727 (Dec. 30, 2016). *See, e.g.,* Hamilton, Causes and Consequences of the Oil Shock of 2007–2008, Brookings Paper on Economic Activity (2009); Chevallier, Price Relationships in Crude oil Futures: New Evidence from CFTC Disaggregated Data, Environmental Economics and Policy Studies (2012).

[16] *Platinum, gold slide as dollar soars; palladium eases off record*, Reuters (Sept. 30, 2019), *available at*: https://www.reuters.com/article/global-precious/precious-platinum-gold-slide-as-dollar-soars-palladium-eases-off-record- idUSL3N26L3UV.

[17] Between 2014 and 2017, the CME Group lowered the spot month position limit in the contract four times, from 650, to 500, to 400, to 100, to the current limit of 50 (NYMEX regulation 40.6(a) certifications, filed with the CFTC, 14-463 (Oct. 31, 2014), 15-145 (Apr. 14, 2015), 15-377 (Aug. 27, 2015), and 17-227 (June 6, 2017)), *available at*: https://sirt.cftc.gov/sirt/sirt.aspx?Topic=ProductTermsandConditions.

[18] Palladium futures were at $1,087.35 on Jan. 2, 2018 and at $1,909.30 on Dec. 31, 2019. Historical prices *available at*: https://futures.tradingcharts.com/historical/PA_/2009/0/continuous.html.

[19] 78 Fed. Reg. 75,694 (Dec. 12, 2013).

[20] 64 Fed. Reg. 24,038 (May 5, 1999).

[21] Appendix B, paragraph (a).

[22] Appendix A, paragraph (a)(6).

[23] Preamble discussion of Exemptions from Federal Position Limits.

[24] Elimination of CFTC Form 204.

[25] Preamble discussion, Execution Summary, section 6. Legal Standards for Exemptions from Position Limits.

[26] 78 Fed. Reg. 75,717 (Dec. 12, 2013).

[27] Id.

[28] Appendix A, paragraph (a)(11).

[29] DCM Core Principle 5 (sec. 5 of the CEA, 7 U.S.C. § 7) (implemented by CFTC regulation 38.300) and SEF Core Principle 6 (sec. 5h of the CEA, 7 U.S.C. § 7b-3) (implemented by CFTC regulation 37.600).

[30] Regulation 150.9.

[31] Preamble discussion of regulation 150.9, including references to cases pointing out the extent to which an agency can delegate to persons outside of the agency.

[32] Regulation 150.9(e)(6).

[33] Sec. 4a(5).

[34] Regulation 150.1.

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