SPEECHES & TESTIMONY

Statement of Chairman Heath P. Tarbert in Support of Proposed Rule on Speculative Position Limits

January 30, 2020

I am pleased to support the Commission's proposed rule on limits for speculative positions in futures and derivatives markets. Today's proposal is a pragmatic approach that will protect our agricultural, energy, and metals markets from excessive speculation. But just as importantly, it will ensure fair and easy access to these markets for businesses producing, consuming, and wholesaling commodities under our jurisdiction.

When I came to the Commission, I set out several strategic goals. Among them is to regulate our derivatives markets to promote the interests of all Americans. Another goal is to enhance the regulatory experience of market participants. The proposal we are issuing today will deliver on both. We also drew from each of our agency core values to craft it—commitment, forward-thinking, teamwork, and clarity. Clarity is of particular importance here because, ultimately, markets and their participants deserve regulatory certainty. We provide that today.

Making our Markets Work for the American Economy

If adopted, our proposal will help ensure that futures markets in agricultural, energy and metals commodities work for American households and businesses. Farmers, ranchers, energy producers, utilities, and manufacturers are the backbone of the American economy. Our derivatives markets generally, and in particular the markets addressed in this proposal, are designed specifically to allow these businesses to hedge their exposure to price changes.

This Commission's proposal will protect Americans from some of the most nefarious machinations in our derivatives markets. First, capping speculative positions in the covered derivatives contracts will help prevent cornering and squeezing. Such manipulative schemes can cause artificial prices and can injure the users of commodities linked to the futures markets. Limiting speculative positions can also reduce the likelihood of chaotic price swings caused by speculative gamesmanship. In effect, position limits should help ensure that prices in our markets reflect real supply and demand.

Position limits are not a solution born inside the Washington Beltway and imposed on the market from afar. Instead, they are one of many tools that exchanges have used since the 19th century to mitigate the potentially damaging effects of excessive speculation. They are a pragmatic, Midwestern solution to a real-world problem. Recognizing the usefulness of exchange-set limits, the Commission has worked collaboratively with our exchanges since 1981 to put sensible position limits and accountability levels on speculative positions in all physical commodity futures markets.

Our proposal would also end the "risk management" exemption that has allowed banks, hedge funds, and trading firms to take large and purely speculative positions in agricultural markets. Nearly a decade ago, Congress directed the Commission to address this issue. Today we are acting.

Some observers have gone so far as to call position limits “at best, a cure for a disease that does not exist or a placebo for one that does.”[1] I respectfully disagree. To be sure, position limits are not a silver bullet against the damaging impact of excessive speculative activity. But I also believe, as did Congress when it amended the Commodity Exchange Act, that position limits can help to “diminish, eliminate, or prevent” potential damage to the commodities markets that are so critical to our real economy.

Still, setting limits requires balancing the competing need for liquidity in our markets against the potential for disruptive speculative positions. I believe that the spot month levels we are proposing are reasonably calibrated. They are based on the current rule of thumb that limits should be no more than 25 percent of the deliverable supply of the referenced commodity, in order to prevent corners and squeezes that everyone can agree are bad for the market.

For the nine grain futures contracts currently subject to position limits,[2] revising non-spot limits required the Commission to consider an additional complication. Eliminating the risk management exemption could potentially take away a source of liquidity further out the curve. For a farmer who needs to hedge the price risk on crops that are still in the ground, a bank with a risk management exemption may be the only willing buyer. To mitigate the impact of eliminating the risk management exemption, we have raised the non-spot month limits for the grain contracts. This should allow a broader set of market participants to provide liquidity and help farmers hedge their crop risk as far in advance as they need.

Ensuring Access for Bona Fide Hedgers

Position limits is the rare rule where the exception is as important as the rule itself. It cannot be said too often that these limits are on *speculative* activity. Congress has always intended that positions that are a bona fide hedge of price risk should not be subject to limits.

It is critical, therefore, that we not disrupt the regulatory experience of American producers, middlemen, and end-users of commodities. The greatest risk of a position limits rule is that hedgers are caught in the limits aimed at speculators. This could reduce their ability to protect themselves from risk, which could in turn negatively impact the broader economy. If a farmer cannot offset a risk on next year’s crop —if a refiner cannot offset a risk on crude oil for a new plant—or if a wholesaler cannot offset risks on inventory it is buying, those businesses will not expand their operations.

Any position limits rule must therefore be written with those hedging needs in mind. Congress and the American people expect nothing less. The proposal addresses those needs through (i) a broad exemption for “bona fide” hedging, and (ii) a streamlined and non-intrusive process for recognizing those exemptions.

On the first point, the proposal will expand the types of hedging strategies that are presumed to meet the bona fide hedging definition—and therefore be eligible for an exemption from position limits. For the first time, we have included anticipated merchandising, meaning that wholesalers and middlemen connecting producers and consumers could more readily hedge their risks. We have also expanded the definition to conform to the hedging strategies that are common in energy markets. This will ensure that the new federal speculative limits on energy markets do not inadvertently undermine the producers, refiners, pipeline operators, and utilities that keep this country running.

On the second point, we have built on prior proposals to create a practical and efficient way for hedgers to avail themselves of the bona fide hedging exemption. Creating burdensome red tape or slowing down approvals to take on hedging positions could result in lost business opportunities for the participants we are called to protect.

For parties whose hedging needs fit within the enumerated list, they could exceed federal position limits without requesting approval from the Commission. They also would not need to submit information on their cash market positions—a duplicative and burdensome exercise that is better handled by the exchanges.

For parties whose hedging needs do not fit within the enumerated list, we are offering a process whereby an exchange could evaluate that hedging need. If the exchange finds that the need is a bona fide hedge not captured by our list, the exchange would notify the Commission. Unless the Commission votes to reject it within 10 business days, the exchange's recognition would be deemed effective for purposes of federal position limits. Given our expanded definition of bona fide hedging, I anticipate that it would be a rare case that a market participant finds its legitimate hedging needs are not already covered in the list of enumerated exemptions. Still, this process would provide flexibility and legal certainty, without excessive red tape.

Striking the Right Balance

The Commission has grappled with position limits for a decade. The 2011 proposal was finalized, but struck down by a court because of concerns over its legal justification. Subsequent proposals in 2013 and 2016 were never finalized, following pushback from market participants about access to bona fide hedge exemptions. The Commission and staff have worked with diligence and good faith to solve this puzzle. There are difficult, often competing interests to address in this seemingly simple rule. If an easy solution exists, I have no doubt that the Commission would have found it.

Today's proposal is the culmination of ten years of effort across four Chairmen's tenures. I sincerely thank my predecessors, as well as the Commission staff, who have worked so hard for so long to strike the right balance. Each proposal and every piece of feedback has helped improve the proposal before the Commission today. I believe that the proposal offers the pragmatic, workable solution that would protect markets from corners and squeezes while preserving the ability of American businesses to manage their risks.

Putting the Burden in the Right Place

Finally, I want to draw attention to one fundamental shift in approach between prior position limits rules and the present proposal. Previously, the Commission had read the Commodity Exchange Act to require federal limits to be placed on every futures contract for a physical commodity. This would have required the Commission to evaluate approximately 1,200 individual contracts to determine the appropriate levels.

The 2011 position limits rule was challenged in court on this ground and was struck down. The court found that the statute was ambiguous about whether the Commission must impose limits on all futures, or whether it should impose limits only "as the Commission finds are necessary[.]" The court said that "it is incumbent upon the agency not to rest simply on its parsing of the statutory language. It must bring its experience and expertise to bear in light of competing interests at stake to resolve the ambiguities in the statute."[3]

The Commission is now bringing its experience and expertise to bear on this matter. We have taken a big picture approach to determine when position limits are in fact necessary. In short, we are proposing that speculative limits are necessary for those futures contracts that are physically delivered and where the futures market is important in the price discovery process for the underlying commodity. The Commission also examined whether a disruption in the distribution of that commodity would have a significant impact on our economy. This has led us to propose limits on 25 physically delivered futures contracts,[4] which covers the vast majority of trading volume and open interest in physically delivered derivatives. In addition to the nine grain futures contracts currently subject to federal limits, this includes the largest energy, metals, and other agricultural futures contracts.

Position limits are like medicine; they can help cure a symptom but can have undesirable side effects. And like medicine, position limits should be prescribed only when necessary. I believe this change in the underlying rationale for the proposal will require thoughtful reflection before imposing additional position limits on additional contracts in the future. Position limits will always create a burden on someone in the market—whether a compliance burden on parties having to track their positions relative to limits, or potentially the loss of a business opportunity because the risks cannot be hedged.

The statutory provisions on position limits can reasonably be read in two ways. The first reading would put the burden on the Commission to find position limits to be necessary before imposing them on new contracts. The second reading would mandate federal limits on all futures contracts irrespective of any need, reflexively putting placing a burden on all markets and all market participants. Given the choice of burdening a government agency or private enterprise, I think it is more prudent to put the burden on the government. That is what today's proposal does. As Thomas Jefferson said, "Government exists for the interests of the governed, not for the governors."

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[1] (https://www.cftc.gov/PressRoom/SpeechesTestimony/dunnstatement101811)

[2] The proposal would not set non-spot month limits on the 16 contracts that are not currently subject to federal position limits.

[3] Int'l Swap Dealers Assoc. v. CFTC, 887 F.Supp.2d 259, 281 (D.D.C. 2012).

[4] The proposal would also impose limits on approximately 400 other futures contracts that are linked, directly or indirectly, to the 25 core physically delivered contracts.