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farmdoc DAILY

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More on Position Limits, Excessive Speculation and the Dodd-Frank Act

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A previous *farmdoc daily* post (available here) discussed the history and operation of position limits – the maximum number of futures contacts that can be owned or controlled by an individual or entity – as a way to control excess speculation. To help our readers better understand this issue, today we will review the CFTC's position limit rules that were struck down recently by Judge Robert L. Wilkins, with a focus on the agricultural commodities. A future post will explore Judge Wilkins' ruling and discuss possible next steps by the CFTC.

In November 2011 the CFTC published new position limit rules for 28 "core referenced futures contracts" on physical commodities, which were scheduled to become effective on October 12, 2012. These rules also would apply to options contracts on these futures contracts, and swaps that are economically equivalent to the exchange-traded contracts on these same underlying commodities. Of these 28 commodities, 19 are major agricultural commodities (see Table 1), so these new position limits would have a substantial impact on the agricultural sector.

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Table 1. Core Referenced Futures Contracts on Physical Commodities

Contract	Exchange
Corn	CBOT
Oats	CBOT
Soybeans	CBOT
Soybean Meal	CBOT
Soybean Oil	CBOT
Rough Rice	CBOT
Wheat	CBOT
Wheat	KCBT
Wheat	MGE
Class III Milk	CME
Live Cattle	CME
Feeder Cattle	CME
Lean Hogs	CME
Cotton	ICE
Cocoa	ICE
Coffee	ICE
Orange Juice	ICE
Sugar #11	ICE
Sugar #16	ICE
Gold	COMEX
Silver	COMEX
Copper	COMEX
Platinum	NYMEX
Palladium	NYMEX
Natural Gas	NYMEX
Crude Oil	NYMEX
RBOB Gasoline	NYMEX
Heating Oil	NYMEX

Spot limits, which apply to contract months in or near the delivery or final settlement period, would be set at one-quarter of the estimated spot-month deliverable supply for both physically-delivered and cash-settled contracts. For physically-delivered contracts this is consistent with previous CFTC regulations, but it would be a substantial change for cash-settled agricultural contracts such as milk, hogs and feeder cattle. Prior to Dodd-Frank, the CFTC allowed spot limits "no greater than necessary to minimize the potential for manipulation or distortion." In practice, this level has been as high as 100% of the physical commodity underlying the cash-settlement index. This is possible because it is mathematically impossible for an individual or entity holding that amount of futures contracts to profitably distort the final settlement value by bidding up (or offering down) the price on cash market transactions used in the calculation of the cash settlement index.

Under Dodd-Frank, reducing these spot limits to as little as 25% of their current levels could require many hedgers to lift a portion of their hedges prior to final settlement, leaving them exposed to unfavorable price changes. In addition, since liquidity tends to decline as a contract approaches expiration, hedgers could have difficulty liquidating positions to reach these lower spot limits. This could cause them to refrain from hedging much of their expected purchases or sales in future periods.

Despite the CFTC's expanded use of the "one-quarter of deliverable supply" metric, the new regulations provide no direction on how deliverable supply is to be measured. Nevertheless, each year the exchanges would be required to submit to the CFTC an estimate of the deliverable supply for each agricultural commodity, along with the supporting data and methodology used to develop each estimate. The CFTC would then either use the exchange estimate for a particular commodity, or develop its own estimate and establish the spot limit at that level. The CFTC's effort to create a more objective method for establishing spot position limits is commendable. However, granting itself veto power without providing criteria for the measurement or evaluation processes could expose the CFTC to pressure from groups and individuals demanding higher or lower levels each time the limits are reviewed, and further politicize the already-controversial position limits issue.

Non-spot limits for most commodities would be based on average month-end open interest levels of the corresponding futures and options contracts with the highest open interest over the previous 12 or 24 calendar months, whichever is larger. A similar system has been used successfully in many agricultural commodities for a number of years, and this approach would allow non-spot position limits to automatically adjust up or down in response to changes in the size of the market. This calculation also would include month-end open interest on commodity swaps, once the necessary swaps data become available. However, the CFTC chose to not extend this objective approach to the nine oldest agricultural commodities – corn, oats, wheat (at all three exchanges), soybeans, soybean oil, soybean meal, and cotton. Instead, the CFTC would continue to rely on subjective and non-transparent methods to establish and adjust non-spot limits for these so-called "legacy" contracts.

All agricultural commodities also would be subject to all-months-combined or "aggregate" limits, which control the total number of futures contracts on the same side of the market (long or short) that may be held in a particular commodity. Readers of last week's post will recall that livestock and dairy contracts currently do not have all-months-combined limits. Deliverable supplies and prices in any futures month of a non-storable, continuously-produced commodity are largely independent of supplies and prices in other months, and therefore all-months-combined limits serve no economic purpose for these types of commodities. However, all-months-combined limits would return under the CFTC's new rules, based on average month-end open interest levels for all contract months combined of the corresponding futures and options contracts over the previous 12 or 24 calendar months.

In October 2011 the five CFTC Commissioners voted 3-2 to approve these new position limit rules, following a review period that generated 13,000 comment letters. The two Commissioners who voted against the proposal expressed concerns about the economic impact of these new regulations on hedgers, and even the Commissioner who cast the deciding vote with the majority expressed his belief that these new position limits may "harm the very markets we're trying to protect."

The International Swaps and Derivatives Association (ISDA), a trade group representing participants in the market for over-the-counter derivatives, and the Securities Industry and Financial Markets Association (SIFMA), a trade group representing securities firms, banks and asset managers, filed suit in the US District Court for the District of Columbia to overturn the CFTC's new regulations on position limits, claiming that the CFTC had overstepped its authority under the Dodd-Frank Act. Judge Robert L. Wilkins agreed, and on September 28, 2012 he issued a ruling that vacated – "tossed out," in everyday language – the CFTC's new rules regarding position limits, including all of the changes to the agricultural contracts described above, and sent everything back to the CFTC for further work.

Press reports called this ruling a "victory for speculators" and claimed it would allow these markets to operate "without limits." In fact, Judge Wilkins' ruling simply blocked the implementation of the CFTC's new rules, and allowed the current system of position limits governing these 28 core commodities to remain in effect.

A review of Judge Wilkins' ruling, the alternatives available to the CFTC, and the potential impact on the agricultural markets will be covered in an upcoming *farmdoc daily* post.