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

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Two recent *farmdoc Daily* posts available here and here discussed the history of position limits and reviewed the CFTC's recently-overturned position limit rules, respectively. Today's post is the last in this series, and will examine the court ruling and discuss possible next steps by the CFTC.

Judge Robert L. Wilkins of the US District Court for the District of Columbia ruled on September 28, 2012 that the CFTC had overstepped its authority with its new system of position limits on 28 physical commodities. This decision was the result of a suit filed by 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. ISDA and SIFMA claimed that the CFTC failed to demonstrate that its new position limit rules were "necessary and appropriate" under the Commodity Exchange Act, as amended by Dodd-Frank. In addition, they claimed that the CFTC had discretion regarding whether or not to establish position limits and the manner in which any position limits would operate. The CFTC argued that Dodd-Frank "mandated" these new limits, the 28 commodities to which they would apply, the levels of these new limits and the manner in which they would operate, so the CFTC had no discretion in this matter.

Both sides claimed the language of the Commodity Exchange Act, as amended by Dodd-Frank, was "clear and unambiguous" and could easily be understood by "plain readings." Readers can view the wording at the heart of this dispute beginning at page 44 of the court document here Judge Wilkins ruled that the law is ambiguous, and rather than choose sides in this matter he sent the entire package of new position limit rules – including all of the changes to the agricultural contracts described in our previous post – back to the CFTC for further work. Meanwhile, the existing rules governing position limits will remain in place.

What will happen next? The CFTC could file an appeal – and at least one Commissioner has been publicly calling for just that – but a successful appeal should be based on legal points, not just wanting a "do-over" because the first decision didn't turn out favorably. According to news reports, the CFTC's general counsel has requested a vote on proceeding with an appeal, so it appears this approach may be pursued, if for no other reason that it has fewer shortcomings than the CFTC's other choices.

Alternatively, the CFTC could try to push through some new rules on a “fast track” basis, but these likely would be stopped by further legal action until the problems identified by Judge Wilkins have been resolved. A third solution would be for Congress to amend the offending sections of the Commodity Exchange Act, but with an election just around the corner, a lame-duck Congress after that, and continued deep political divisions over Dodd-Frank, a legislative solution anytime soon seems unlikely.

Judge Wilkins’ decision drew particular attention to the “necessary and appropriate” requirement, which could lead to further problems in implementing a new position limits regime. Despite the longstanding use of position limits, the evidence on their effectiveness is surprisingly thin.

Much of the controversy and ambiguity surrounding speculation can be traced back to the original language of the Commodity Exchange Act as enacted in 1936. Congress cited “Excessive speculation in any commodity… causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity…” as the disease for which position limits are the cure. But at what point does speculation become “excessive”? Does it require “sudden or unreasonable fluctuations or unwarranted changes in the price” before it is considered “excessive”? If so, what criteria should be used to determine if a price change is “sudden” or “unreasonable” or “unwarranted”? The Commodity Exchange Act and CFTC regulations are silent on these questions.

In addition, if someone wants to amass a large long (or short) position in futures or options, one or more others together must take an equally large short (or long) position. The offsetting nature of these long and short positions makes it difficult to construct an analytical framework under which one might find some type of expected price impact, one way or the other. Perhaps this explains why most studies, including a landmark report by CFTC staff in 2008, have found little connection between speculative activity and futures prices.

Furthermore, the historical record shows that “squeezes,” “corners” and similar types of market distortions cannot be accomplished by the passive holding of futures alone. They also require a substantial presence in the underlying cash (physical commodity) market, as well as active participation in the delivery or final settlement process. For this reason spot-month position limits play an important role in preventing manipulation, but non-spot limits – and for certain commodities, all-months-combined limits – may serve little purpose beyond assisting in the orderly liquidation of positions.

“Speculative” position limits also affect producers and other commercial users of the futures markets, so hedgers have a stake in the final outcome, too. Meeting the “necessary and appropriate” requirement could pose some serious challenges for the CFTC, so this matter probably will not be resolved for several months. Until then, the existing system of position limits will remain in effect.