January 13, 2012

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581

Re: Position Limits for Futures and Swaps
(CFTC RIN 3038-AD17)

Dear Mr. Stawick:

Better Markets, Inc.[1] appreciates the opportunity to comment on the above-captioned Interim Final Rule (the "Interim Final Rule") published by the Commodity Futures Trading Commission ("CFTC") on November 18th 2011, the purpose of which is to establish position limits for certain physical commodity derivatives, as required by and pursuant to provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[2]

INTRODUCTION

In the Interim Final Rule, the CFTC sought public comment on several topics that are critical to the success of any position limit regime:[3]

> [T]he Commission is seeking comments on the impact of the interim final rule or any alternative ratio on:
>
> (1) The protection of market participants and the public;
>
> (2) the efficiency, competitiveness, and financial integrity of the futures markets;
>
> (3) the market's price discovery functions;

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1 Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

2 While this letter responds specifically to the questions posed in the Interim Final Rule, it builds upon the information contained in the comment letter filed by Better Markets on March 28, 2011, which is incorporated hereby as if fully set forth herein. *See* Better Markets, "Position Limits for Derivatives," March 28th 2011 ("March 28 Position Limits Letter"), *available at* http://bettermarkets.com/rulemaking/better-markets-comment-letter-position-limits

3 Federal Register/Vol. 76, No. 223/Friday, November 18, 2011/Rules and Regulations, pp71637-8

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(4) sound risk management practices; and

(5) other public interest considerations.[4]

As discussed below, all five topics, including in particular protection of markets and the public as well as price discovery, are at risk if the Interim Final Rule is not modified to take into account data discussed herein and set forth in the attached Appendix A.

New and significant evidence, data and analysis demonstrate that, as currently designed, the CFTC's *pro forma* position limits regime will not diminish excessive speculation, as it is mandated to do. The CFTC must change the regime contained in the Interim Final Rule to make it effective and improve the efficiency and financial integrity of the commodities markets by removing a dangerous speculative presence which is currently distorting the price discovery mechanism. Such changes will also protect market participants and the public.

The Dodd-Frank Act gives the CFTC the power and authority to do this, which is necessary for the protection of the public interest and for the CFTC to fulfill its statutory mandate.

DISCUSSION

To make the position limits regime effective, the CFTC must target the "group or class of traders" collectively known as "Commodity Index Traders."[5]

The Dodd-Frank Act gave the CFTC a clear mandate to place position limits on any group or class of traders posing a threat to the integrity of the price discovery process in commodities markets.[6] Specifically, Congress enumerated four objectives that the CFTC must seek to achieve as it sets position limits.[7] First and foremost on the list, and "to the maximum extent practicable," **the agency must "diminish, eliminate, or prevent excessive speculation."** Other objectives include ensuring "sufficient market liquidity for bona fide hedgers," and ensuring that "the price discovery function of the underlying market is not disrupted." These goals are clearly aimed not only at excessive speculation *per se*, but also at the ancillary harms that excessive speculation can cause: destruction of the hedging environment and distortion of the price discovery function.

In the Federal Register release containing the Interim Final Rule, the CFTC indicated that it "welcomes further submissions of studies" pertaining to groups or classes of speculators that may have a damaging effect on commodity markets if they are not subject to targeted position limits.[8]

In the March 28 Comment Letter, extensive evidence was presented that Commodity Index Traders[9] represent just such a class of harmful participants, and should therefore be severely restricted or eliminated using position limits.

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4 Op. Cit. 71638
5 Dodd-Frank Act § 737(a)(3)(A), 7 U.S.C. § 6a(a)(1).
6 Op. Cit
7 Dodd-Frank Act § 737(A)(4), 7 U.S.C. § 6a(A)(3)(B).
8 Op. Cit p.71658
9 Defined terms herein are as defined in the attached Appendix A.

The evidence in that letter documented that some Commodity Index Traders have come to control more than 50 percent of open interest in a given commodity futures market. The evidence showed that flows of Commodity Index Trader investments were correlated with prices, and uncorrelated with fundamental supply and demand for commodities. Thus, Commodity Index Traders have a distorting effect on prices, moving them away from the level dictated by true supply and demand.

Since then, new evidence has come to light, showing that the monthly "Roll" period during which Commodity Index Traders must close out expiring contracts and replace them with new, longer-dated contracts, also has a distorting effect on price discovery. This evidence is attached in full at Appendix A. Here are some highlights:

- Historically, under typical trading activities in the commodity markets, price curves in the commodities futures markets have been predominantly backwardated. This traditional price curve structure is commonly explained in terms of "convenience yield." The traditionally backwardated price curves become upward sloping. However, since the advent of Commodity Index Funds, prices of many commodities have moved into a pronounced contango state.
    - New research has, for the first time, quantified the impact of Index Fund trading on this curve shift. That analysis has also confirmed what prior evidence has suggested: that Index Funds have been the driving force behind this change in the price structure of commodity futures.
- When buyers and sellers see a price curve in contango, it signals that **even with the convenience yield built into today's price, tomorrow's price will almost certainly be higher.** That signals producers to delay production, and consumers to buy more now (even if this doesn't necessarily show up in patchy data on inventories). This causes exaggerated scarcity in the short run, which pushes prices up sharply. In the long run, when the delayed production comes on to the market while at the same time demand declines because consumers have already stocked up or cut back, the bubble bursts, and prices come crashing down.
- The largest group of speculative trading funds is based on the Standard & Poor's Goldman Sachs Commodity Index (GSCI), which must roll forward their expiring futures contracts during a set period of each month, from the 5th to 9th business day. [10] The next-largest family of Commodity Index Funds, which tracks the Dow Jones – UBS Index (DJ-UBS), has a similar, overlapping time period. The analysis focused precisely on the GSCI window (which includes the overlapping portion of the DJ-UBS window). As such, it was designed to capture the majority of index fund roll activity.
- Specifically, the analysis examines the behavior of futures price spreads before, during and after the time each month that the speculative trading funds closed out their expiring futures contracts and purchased new futures contracts.

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[10] Since the GSCI TR index is calculated **as though** all rolling occurred during this window, any Commodity Index Fund sponsor tracking the index must either conduct all rolling activity at this time, or else take on proprietary risk.

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- The data show overwhelming evidence that the GSCI Roll Cycle systematically distorts forward commodities futures price curves towards a contango state. This causes speculative "boom-bust" cycles by changing the incentives of producers and consumers of storable commodities, and also by sending misleading and non-fundamental price signals to the market.

- The analysis looked closely at the behavior of prices during the monthly GSCI Roll Period. The primary commodities studied were NYMEX WTI Crude Oil and CBOT Wheat. The analysis was also extended to NYMEX Heating Oil, CBOT Corn, NYMEX Natural Gas, and CME Live Cattle.

- The research found that during the Roll, the price spread between the expiring contract and the new longer-dated contract (which the speculative trading fund must buy) increases, creating a "contango" price curve. The data also show that this bias towards contango is generally absent during the rest of the trading month, clearly suggesting that the persistent contango that has been witnessed in many commodities over the last several years is generated by the speculative trading funds activity rather than supply and demand conditions.

- The analysis also found that the contango bias during the Roll period did not exist prior to the rapid expansion of Commodity Index Funds in 2004. The research specifically analyzed the same trading dates on which the Roll now occurs, going back more than 25 years. Bias towards contango simply was not present prior to the creation of the Commodity Index Fund.

- Although there were some fundamental supply and demand events that appeared to give a partial explanation of the change in the price curves (e.g. crude oil delivery bottlenecks at Cushing, OK), their occurrence did not match accurately either the timing or magnitude of the shift.

- This clearly indicates that there is indeed a hugely misleading price signal generated by the activities of the Commodity Index Funds and other speculators who may be trading around the Roll. The persistent contango of recent years is not the result of some pre-existing phenomenon, whether fundamentals- or market-based. Since this price signal is not related to actual supply and demand fundamentals, the consequence is to drive prices away from their true value. Because the phenomenon is persistent, and is not arbitraged away, it has significant long-term implications, and tends to promote boom-and-bust price cycles.

CONCLUSION

The Commission has made a good first step to implement the law, despite massive resistance from industry participants who wish to continue their lucrative speculation business as usual and pretend that the financial crisis and commodity crisis of 2008 never occurred. However, to fulfill the statutory mandate to "diminish, eliminate or prevent excessive speculation," more must be done. This new research demonstrates that Commodity

Index Funds are systematically distorting price curves into a contango state. There can be no question that this constitutes a breach of the price discovery function in which prices and price curves should be determined by fundamental supply and demand factors alone, not speculative financial investment flows.

The Final Rule and Interim Final Rule presented in November do not go far enough. By failing to specifically target the single most damaging speculative presence in the commodity markets, Commodity Index Traders, the rules fail to protect market participants and the public from unwarranted price swings in commodities prices. This poses a threat to the efficiency, competitiveness, and financial integrity of the markets, by allowing one group of traders to systematically dominate and thereby undermine the price formation process.

The commission must therefore specifically target the "group or class or traders" collectively known as Commodity Index Funds and radically reduce or eliminate their presence in the commodity markets.

Sincerely,

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President & CEO

David Frenk
Director of Research

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