BETTER MARKETS

– FACT SHEET –

The CFTC's Forthcoming Final Position Limits Regulations Almost Certainly Will Not Limit Excessive Speculation

After ten years of rulemaking, the Commodity Futures Trading Commission (CFTC) has scheduled a public meeting (on October 15, 2020) to consider a final speculative position limits framework for derivatives on certain physical commodities. From all indications, the forthcoming final rulemaking likely will codify the CFTC's position limits framework largely as proposed in early 2020.

Better Markets filed a comment letter detailing the critical flaws of that proposed rulemaking in May 2020.

I. The Big Picture: The Fundamental Role of Speculative Position Limits

Commodity futures markets have existed in the United States since at least 1865. Since their inception, these futures markets have provided two primary and valuable functions for physical commodity market participants (the actual consumers and producers of the physical commodities, like oil, wheat, and cotton). As far back as the Commodity Exchange Act of 1936, Congress recognized that the commodity futures markets provide physical market participants with a means (1) to offset price risk; and (2) to facilitate price discovery. Since 1974, Congress has entrusted and required the CFTC to preserve these two vital functions and to protect them against the threat of fraud, manipulation, and excessive speculation.

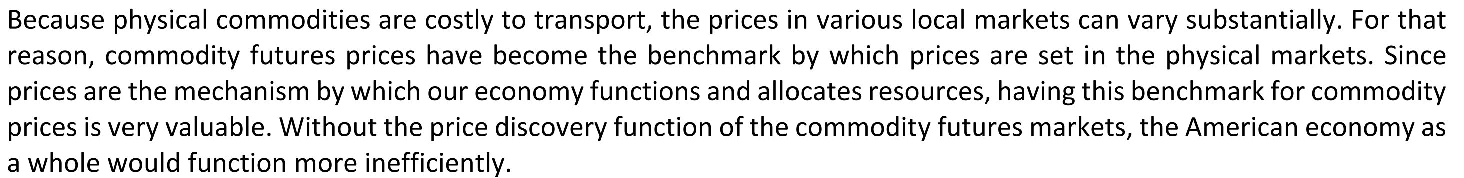
Managing Price Risk

Commodity futures markets provide a way for physical commodity market participants to hedge against the risk of price fluctuations. For example, a physical commodity producer, such as an Iowa corn farmer, who is able to sell futures contracts against the amount of the expected harvest can lock in a price for corn and thereby eliminate or reduce price risk. A physical commodity consumer, such as a cereal manufacturer, who is able to buy futures contracts for the amount of corn it needs to produce corn flakes can lock in its input costs and eliminate or reduce its price risk. These physical commodity market participants benefit because they are not at risk from price fluctuations and can therefore plan effectively for the future of their businesses.

Because food, energy and industrial metals form the basic building blocks of our economy, this risk management function of the derivatives markets and financial health of physical commodity market participants are vital to the overall health of the American economy.

Facilitating Price Discovery

Properly functioning commodity futures markets also provide a way for physical commodity market participants to determine the current market price for physical commodities in the overall marketplace. For example, the farmer in Iowa needs to know the prevailing price for corn before selling to a local consumer. Knowing the futures price allows the farmer to determine if it makes more sense to ship the corn somewhere else in order to get a better price. Likewise, the cereal manufacturer needs to know the prevailing price for corn so that it can negotiate a fair price with its suppliers.



Because physical commodities are costly to transport, the prices in various local markets can vary substantially. For that reason, commodity futures prices have become the benchmark by which prices are set in the physical markets. Since prices are the mechanism by which our economy functions and allocates resources, having this benchmark for commodity prices is very valuable. Without the price discovery function of the commodity futures markets, the American economy as a whole would function more inefficiently.

The Role of Speculators, and the Substantial Risks of Excess Speculation

Speculators are participants in the commodity futures markets who do not have an underlying physical commodity position to hedge. Generally speaking, they are hoping to profit from changes in futures prices. When commodity futures markets function as they should, speculators provide an essential function: they accept price risk in exchange for providing liquidity.

For example, if our corn farmer wants to sell futures contracts but the cereal company is not in the market that day buying, who can the farmer sell them to? The answer is that speculators are willing to buy from the corn farmer one day and sell to the cereal company another day. For this reason, the commodity futures markets need a certain amount of speculation to ensure sufficient liquidity for legitimate hedgers.

It has always been recognized, however, that the commodities futures markets are capable of reaching a state of excessive speculation. This occurs when speculators replace physical hedgers as the dominant force in the marketplace.

When commodity futures markets become excessively speculative, the price discovery function becomes damaged or distorted, and eventually destroyed. **The dramatic influx of speculators—like Wall Street banks, exchange-traded funds, and commodity index speculators—has now brought us well past the tipping point and commodity futures markets have descended into a state of excessive speculation.** When excess speculation damages the price discovery process, commodity futures prices do not correlate with spot prices and the markets cannot serve their two fundamental purposes.

Speculative Position Limits

One remedy for excessive speculation has been used since at least 1936: speculative position limits. The position limits put in place under the Commodity Exchange Act did a relatively good job of protecting agricultural commodity futures markets for 50 years. More recently, however, the erosion and elimination of speculative position limits has made it possible for hundreds of billions of dollars of Wall Street and other capital to flow unimpeded into the commodity futures markets. This unbridled flow of money is one of the principal causes of the dramatic price volatility seen in some commodity futures markets (e.g., the crude oil futures market).

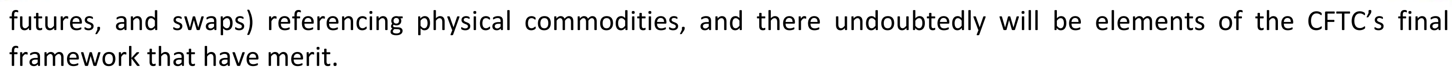
The CFTC must re-establish meaningful speculative position limits in order to reverse the flow of speculative money and to wring the excess out of the commodities futures markets. Speculative position limits worked effectively for decades and will work again without unintended consequences . . . if the CFTC takes effective and politically courageous action.[1]

II. The Details: The CFTC's Likely Position Limits Framework

This week, the CFTC will again consider a final speculative position limits framework for derivatives on certain physical commodities.

In a limited sense, any progress on a final position limits framework is a positive development. Better Markets has long called on the CFTC to lawfully implement a speculative position limits framework for derivatives (futures, options on

[1] For a reasonably high-level but more detailed description of the commodity futures markets and the distortive effects of excess speculation, see M. Masters, A. White, The Accidental Hunt Brothers: How Institutional Investors Are Driving Up Food and Energy Prices (July 31, 2008), available at https://loe.org/images/content/080919/Act1.pdf. This fact sheet's description of the commodity futures markets is excerpted, in part, from that special report.



futures, and swaps) referencing physical commodities, and there undoubtedly will be elements of the CFTC's final framework that have merit.

Nevertheless, the CFTC's final rulemaking almost certainly will continue to suffer from significant legal and policy deficiencies, making the overall rulemaking fundamentally flawed and a disservice to Americans who need protection from excessive speculation and the inefficient and unnecessary volatility and boom-bust cycles caused by speculative trading.

The 2020 proposal's five most material deficiencies likely to be finalized at the upcoming public meeting are as follows:

1. **The federal spot-month limits for derivatives on 25 physical commodities likely will represent *significant increases* in permissible speculation.**

   The CFTC's forthcoming final rule may dramatically increase federal position limits for legacy agricultural contracts and establish new federal position limits that greatly exceed most exchange-set limits for derivatives on the other physical commodities. On a positive note, the final rule likely will establish federal spot-month position limits on futures contracts on 25 core physical commodities, as well as linked cash-settled futures and options contracts and economically equivalent swaps.

2. **Federal position limits likely will not apply to non-spot-month derivatives contracts on 16 of the 25 physical commodities**.

   Federal position limits for derivatives on nine agricultural commodities have been implemented for decades for single months beyond the spot month and all-months-combined. Although the final rule likely will expand the reach of federal spot-month position limits to derivatives on additional types of agricultural, energy, and metals commodities, it almost certainly will not apply federal (non-spot-month) single-month and all-months-combined position limits to 16 of the 25 core contracts.

   Furthermore, the default formula used by exchanges to calculate non-spot single-month and all-months-combined position limits almost certainly will be considerably more permissive than the current formula used by the major exchanges.

3. **The final rule likely will dramatically expand (almost triple) the number of *self-effectuating* enumerated exemptions and for the first time, recognize a broad exemption (read, loophole) for anticipatory merchandising**.

   The final rule is almost certain to implement numerous new, expansive, and self-effectuating "hedging" exemptions from position limits, including multiple new exemptions for so-called anticipatory merchandising and other anticipatory trading strategies supposedly in the nature of "bona fide hedging transactions or positions." Those anticipatory hedging exemptions will be next to impossible for the CFTC to police. As a consequence, the CFTC is likely to exclude an unknown percentage of total positions from the federal and exchange limits framework, all but eliminating meaningful constraints on speculation in derivatives markets on key physical commodities.

4. **The CFTC is likely to finalize a new process for recognizing non-enumerated hedging strategies that practically eliminates CFTC oversight.**

   The CFTC is likely to permit exchanges to grant non-enumerated bona fide hedging exemptions for purposes of excluding positions from federal and exchange-set limits. The CFTC's oversight of exchange determinations with respect to such hedging exemptions likely will be limited by the impractically short review periods for exchange-approved hedges. Although the final rule is likely to provide authority for the CFTC (and not its staff) to stay and/or

object to such determinations, the contemplated review process risks reducing the CFTC's supervisory role to mere notice on the most novel and complex hedging applications.

5. **The final rule likely will raise unnecessary administrative hurdles and open avenues for legal challenges to meaningful position limits by interpreting the Commodity Exchange Act (CEA) to require a "necessity" finding before the CFTC can finalize federal position limits.**

   The final rule is likely to include a determination that the CFTC must make an antecedent "necessity" finding that establishing federal position limits is "necessary" for each of the 25 core contracts. In particular, the CFTC is almost certain to include a lengthy legal analysis that reverses the CFTC and CFTC staff's longstanding legal views that ambiguities in the CEA, ***if any***, should be construed to **require** position limits on derivatives on physical commodities.

   That legal analysis, if finalized, contravenes a better reading of CEA's statutory commands and congressional intent (including the reading articulated in the CFTC's 2016 position limits proposal). The "necessity" findings also will unnecessarily raise administrative hurdles and open avenues for legal challenges to the CFTC's position limits framework.

6. **The CFTC's final framework almost certainly will not address the disruptive and distortive effects of excess speculation caused by the massive market footprint of exchange-traded funds, commodity index funds, and similar speculative vehicles.**

   The CFTC's final rule is unlikely to address the disruptive and distortive effects of speculative trading by exchange-traded funds, commodity index funds, and similar speculative vehicles, despite the fact that Congress explicitly amended the Commodity Exchange Act to authorize position limits on any "group or class of traders" and confine certain expansive exemptions.

   In the latter regard, it is possible that the final framework will provide some indirect constraints on speculation through the long-overdue elimination of the (misleadingly named) "risk management" exemption, which is relied upon by Wall Street's largest derivatives dealers.

Better Markets will be unable to support the CFTC's position limits proposal for the above reasons and numerous others discussed in our comment letter.

Under the expected final framework, the potential for implementation of federal position limits that do not actually limit speculation simply remains too great.

October 14, 2020

Better Markets is a public interest 501(c)(3) non-profit based in Washington, DC that advocates for greater transparency, accountability, and oversight in the domestic and global capital and commodity markets, to protect the American Dream of homes, jobs, savings, education, a secure retirement, and a rising standard of living.

Better Markets fights for the economic security, opportunity and prosperity of the American people by working to enact financial reform, to prevent another financial crash and the diversion of trillions of taxpayer dollars to bailing out the financial system.

By being a counterweight to Wall Street's biggest financial firms through the policymaking and rulemaking process, Better Markets is supporting pragmatic rules and a strong banking and financial system that enables stability, growth and broad-based prosperity. Better Markets also fights to refocus finance on the real economy, empower the buyside and protect investors and consumers.

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