BETTER MARKETS

By Electronic Submission

November 10, 2021

Rostin Behnam
Acting Chairman
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Leadership Regarding Position Limits on Physical Commodities

Dear Acting Chairman Behnam,

In a hastily finalized rulemaking published on January 14, 2021, the Commodity Futures Trading Commission ("CFTC") set forth a complex new regulatory framework instituting federal position limits on certain derivatives referencing physical commodities.[1] The CFTC's implementation of *any* federal position limits framework represented long overdue progress, however modest and ineffective.[2] Indeed, you rightly acknowledged in your dissenting statement to the final regulations[3] that the CFTC's framework falls well short of multiple statutory commands of the Commodity Exchange Act ("CEA").[4] In fact, the CFTC's position limits framework institutes or permits position limits that are so high, or that are so narrowly applied, that they fail to prevent excessive speculation except in the most egregious and patently unlawful cases of disruptive trading or manipulation.

If the CFTC is to timely address the multiple position-limits deficiencies (including the six critical defects identified in Section II *below*), not to mention other priorities, the agency's staff must begin considering the issues now and be prepared to act swiftly—but of course, responsibly—in the weeks and months ahead. As you know, given the damaging impact of excessive speculation on the price of everything from oil and gas to plastics and cereal, an effective position limits regime as required by the law is essential to protect Main Street families and small businesses from price volatility and the country's economy from crippling supply and demand mismatches.

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1 CFTC, *Position Limits for Derivatives*, 86 Fed. Reg. 3236 (Jan. 14, 2021).

2 The CFTC's *final* rulemaking broadly implementing federal position limits was vacated in most respects by the U.S. District Court for the District of Columbia almost ten years ago. *See Int'l Swaps & Derivatives Ass'n v. U.S. Commodity Futures Trading Comm'n*, 887 F. Supp. 2d 259 (D.D.C. 2012).

3 *See* CFTC, *Position Limits for Derivatives*, 86 Fed. Reg. 3236, 3486-3488 (Jan. 14, 2021) (noting, for example, that "[w]hile today's final rule purports to respect Congressional intent and the purpose and language of CEA section 4a, in reality, it pushes the bounds of reasonable interpretation by overly deferring to the exchanges and allowing them to take the lead in administering a position limits regime").

4 *See* 7 U.S.C. § 6a; *see also* Better Markets, *Letter to the CFTC Re: Position Limits for Derivatives (RIN 3038-AD99)* (May 15, 2020).

I. The CFTC must determine the extent to which excessive speculation continues to undermine the risk management and price discovery functions of the derivatives markets on physical commodities.

Before outlining six critical flaws in the CFTC's current position limits framework (scheduled for its first compliance date in January 2022), we review the fundamental risk management and price discovery functions of the derivatives markets on physical commodities, the useful role that *limited* speculation can play in the derivatives markets, and the market-integrity benefits of a reasonably designed position limits framework.

A. In revising the position limits framework, the CFTC must protect the fundamental risk management and price discovery functions of the derivatives markets on physical commodities.

The U.S. futures markets have existed in something like their current form since at least the mid-1800s. Since their inception, they have provided two primary and valuable functions for physical commodity market participants (the consumers and producers of the physical commodities, like wheat and cotton):

(1) Managing Price Risk:

A means to offset price risk relating to the production, sale, and purchase of physical commodities; and

(2) Facilitating Price Discovery:

A means to facilitate price discovery (the prices of commodities at key delivery points).

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. In the last regard, the CFTC and its predecessor agencies have been authorized to establish federal position limits on derivatives involving certain physical commodities since 1936.

Managing Price Risk

The U.S. 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 the 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 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. Commodity futures prices have become the standard benchmarks by which prices are set in the physical markets—which, today, are usually based on a differential to the prices established for the most liquid delivery locations set forth in key futures contracts. Prices are the mechanisms by which our economy functions and allocates resources, so having these benchmarks for commodity prices is invaluable. Without the price discovery function of the commodity futures markets, the American economy as a whole would function significantly more inefficiently.

B. <u>In revising the position limits framework, the CFTC must address the substantial risks of excessive speculation, while acknowledging the legitimate but limited role of speculators in the markets.</u>

Speculators are participants in the commodity futures markets who do not have an underlying physical commodity position to hedge. They generally 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 to? The answer is that speculators are willing to step into the market and buy from the corn farmer one day and sell to the cereal company another day.

For this reason, speculators are tolerated in and beneficial to the commodity futures markets to the extent that they 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, as they are today, 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 the realities of the physical markets and the markets cannot serve their fundamental purposes.

<u>Speculative Position Limits</u>

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 speculative dollars from Wall Street financial institutions and others 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 in 2020).

The CFTC must re-establish meaningful speculative position limits 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.[5] In this regard, we are hopeful that you will succeed where many of your predecessors have failed.

II. **<u>The CFTC must take steps to remedy the six primary deficiencies of its position limits framework</u>.**

The CFTC will soon have new leadership to give *de novo* consideration to the position-limits framework. In this regard, we recommend that the CFTC focus on correcting six deficiencies of that current framework:

1. **<u>The federal spot-month limits for derivatives on 25 physical commodities represent *significant increases* in permissible speculation</u>.**

The CFTC's final rule dramatically increased federal position limits for nine legacy agricultural contracts. In addition, it established new federal position limits for derivatives on sixteen other core physical commodities that greatly exceeded most existing exchange-set limits for derivatives on those other physical commodities. The basis for all of these limits should be reconsidered and scrutinized, and the limits themselves should be recalibrated as necessary to protect the risk management and price discovery functions of the markets.

On a positive note, the net effect of the final rule *is* the establishment of at least some 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. That element of the final framework should be retained.

2. **<u>Federal position limits do not apply to non-spot-month derivatives contracts on 16 of the 25 physical commodities.</u>**

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 framework expanded the reach of federal spot-month position limits to derivatives on additional types of agricultural, energy, and metals commodities, it did not apply federal (non-spot-month) single-month and all-months-combined position limits to 16 of the 25 core contracts. The CFTC must remedy that critical omission.

Furthermore, the default formula created by the CFTC that is now used by exchanges to calculate non-spot single-month and all-months-combined position limits is considerably more permissive than the formula previously used by the major exchanges. That, too, should be reconsidered and corrected.

3. **<u>The final rule dramatically expanded (almost tripled) the number of *self-effectuating* enumerated exemptions and for the first time, recognized a broad exemption (read, loophole) for anticipatory merchandising.</u>**

The final framework implemented numerous new, expansive, and self-effectuating "hedging" exemptions from position limits, including multiple new exemptions for so-called anticipatory

[5] For a 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). This letter draws significantly on that report.

merchandising and other anticipatory trading strategies supposedly in the nature of "bona fide hedging transactions or positions." Those anticipatory hedging exemptions will be virtually impossible for the CFTC to police. As a consequence, the CFTC excluded 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. **<u>The CFTC finalized a new process for recognizing non-enumerated hedging strategies that practically eliminates CFTC oversight.</u>**

The CFTC permitted 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 has been all but eliminated by the impractically short review periods for exchange-approved hedges. Although the framework provides 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. **<u>The framework raised unnecessary administrative hurdles and opened 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.</u>**

The final rule included 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. The CFTC also included a lengthy legal analysis that reversed 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 contravenes the better reading of CEA's statutory commands and congressional intent (including the reading articulated in the CFTC's 2016 position limits proposal, to which the CFTC must return). The supposedly required "necessity" findings unnecessarily raise administrative hurdles and open avenues for legal challenges to the CFTC's position limits framework.

6. **<u>The framework did almost nothing to 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.</u>**

The CFTC's final rule did not adequately 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."

III. <u>Conclusion</u>

These deficiencies affect core elements of the final position limits rulemaking and must be reconsidered *de novo*. There is no greater priority. The distortions and volatility arising from excessive speculation in derivatives markets on physical commodities ***directly*** and ***immediately*** impact the prices of critical agricultural, energy, and metals inputs used in the production of *all* goods and services across the U.S. economy. This affects the price of everything from the price of a daily commute to work to the price of a loaf of bread and essentially imposes the equivalent of a speculative "tax" on working families and the world's poor. It is, in effect, an unjustified and unjustifiable massive wealth transfer from producers and purchasers to speculators in violation of a law that was enacted specifically to prevent that outcome.

Thank you for your well-reasoned dissents from the CFTC's ill-considered position limits framework. We urge you to draw on those dissents and lead the agency forward to ensure that it takes the steps necessary to remedy the deficiencies identified above. We must end the anti-social excessive speculation that damages the markets and needlessly impose a "speculative tax" on Main Street families. Please do not hesitate to reach out to discuss these or any other policy matters and/or issues.

Sincerely,

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