Comment on "Notice of Proposed Rulemaking: Position Limits for Derivatives", 17 CFR Part 150 (RIN 3038-AD99)[1]

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Commodity Futures Trading Commission ("CFTC" "Commission")

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The Institute for Agriculture and Trade Policy (IATP) appreciates this opportunity to comment on the Commission's re-proposed position limits rule. IATP thanks the CFTC for its consideration of our March 28, 2011 comments on position limits[3] and will not reiterate those comments here. The following comment concerns a few provisions in the re-proposed rule, and firstly, the CFTC's response to the argument, presented by the International Swaps and Derivatives Association et al. v the CFTC[4], and reiterated by Commissioner Scott O'Malia in his dissent to releasing this proposed rule for comment.

Congressional mandate for position limits v. the ISDA et al argument on "necessity"

According to the ISDA et al lawsuit and Commissioner O'Malia, an ex-ante statistical proof, employing large trader data the Commissioner characterizes as "unreliable and unsuitable" (FR 75841), is required for the CFTC to impose position limits for each contract covered by the rule. We strongly agree with the Commission's conclusion that "In light of these investigations and conclusions [by Congress into excessive speculation in oil, gas and wheat], it is reasonable for the Commission to conclude that Congress did not intend for it to duplicate investigations Congress had already conducted, and did not intend to leave it up to the Commission whether there should be federal limits" (FR 75682). We further agree that the Commodity Exchange Act (CEA) mandates speculative position limits, and the congressional history of amendments to the CEA reinforces that mandate so that no ex ante demonstration of "necessity" of the limits by the Commission is required by law to promulgate them (FR 75865). IATP is grateful that the majority of Commissioners were not persuaded by the ISDA et al argument, which would undermine a crucial statutory foundation of the Commission's work to prevent and diminish excessive speculation.

If the Commission were to assent to the argument that it must use "unreliable and unsuitable" data, such as that resulting from purportedly customized swaps by ISDA et al member organizations, it would fail to produce the ex ante statistical demonstration that the ISDA et al and Commissioner O'Malia demand as probative of the "necessity" for setting and modifying position limits. Although the ISDA's and Commissioner O'Malia's argument is tautology, adorned with an invocation for "evidence based" policy making, there is nevertheless a grain of truth in the Commissioner's dissent.

There has been great improvement in the historical data base for setting position limits since the beginning of mandatory Over the Counter swaps data reporting to the Commission. But much remains to be done to increase the quantity, quality and comprehensiveness of OTC data, particularly from global OTC broker dealers, such as the ISDA et al member organizations. Towards that end, IATP urges the Commission to comment extensively on the Financial Stability Board's consultation paper, released on February 4, on the feasibility of global trade data aggregation standards to prevent circumvention of position limits and other data-based market rules.[5]

Agricultural derivatives contracts and the proposed application of the bona fide hedge exemption to contracts bundled into commodity index contracts

The thousands of comments on the position limit rule, noted by former Chairman Gary Gensler in his concurrence (FR 75840) may seem disproportionate to the relatively small gross notional value of commodity derivative contracts, compared to derivatives based on other underlying assets. The intense interest of commercial hedgers in the position limits rule may seem self-evident, given the large and growing body of non-industry funded academic work demonstrating the distortion of commodity price formation and disruption of liquidity for commercial hedgers.[6] However, we believe that there is a larger public interest in fair and transparent price formation for raw materials that drives public support for position limits.

IATP has a particular interest in the price formation of agricultural commodities, since prices affect not only the economic viability of U.S. farms and ranches, but the food security of net food import dependent developing countries. Prices distorted in the derivatives market are seldom, if ever, undistorted during the Freight on Board to retail food price transmission. Agricultural derivative contract price formation has long ceased to be a function of market demand and the estimated deliverable supply of a specific commodity covered by a derivatives contract.

The bundling of agricultural contracts into commodity index funds and hedge fund investments in agricultural contracts are among the forms of financial speculator intervention that have introduced non-fundamental factor volatility into agricultural price formation, particularly during periods of liquidity stress.[7] Extending position limits from the legacy agricultural contracts to other agricultural contracts, to energy contracts and to metals contracts will reduce the unwarranted price levels and volatility that results within those individual contracts, when they are bundled together by index formulas or when they are traded via index like algorithms.

We support the Commission's proposal to include a definition of "commodity index contract" in the re-proposed rule and to require that reporting entities distinguish price reference data under index contracts vs. non-index contracts. (FR 75697). However, IATP does not, either as a member of the Commodity Markets Oversight Coalition (CMOC) or as an individual organization, support the Commission's proposal to extend the bona fide hedge exemption to commodity indexed contracts covered by the position limit rule (FR 75797, including footnotes 163 and 164). Even with the inclusion of the proposed anti-evasion provision within the "commodity index contract" definition, we do not agree that contracts traded for investors, such as pension funds, who invest in commodity index funds to diversify portfolio risk, merit the bona fide hedger exemption. Simply put, such investors are not hedging price risk in the contracts covered by the rule as commercial risk. Rather such purported hedging activity is a subordinated component of hedging the overall financial risk of their portfolio strategies. The anti-evasion provision in the proposed definition of "commodity index fund" does not change the fact that index investors are hedging financial, not commercial risk. The anti-evasion provision puts the burden of proof on the Commission to show that the index formula and trading algorithms are designed to evade the position limit rule. This is not a burden that the resource oppressed Commission should have to bear.

The criterion of "orderly trading" for determining bona fide hedge exemptions in the era of Automated Trading Systems

The tactical retreat by banks and hedge funds from investing directly in commodity derivatives contracts has had some role in the decreased price levels for some agricultural derivatives contracts.[8] This tactical retreat has been followed by an attack by the largest non-predominantly financial swaps participants, such as Cargill and ADM, on the position limit rule.[9] Since these transnational agribusiness firms qualify for the bona fide hedger exemption from position limits, their ability to manage price risks in the Core Referenced Futures Contracts will not be "derailed," as they allege.

We urge the Commission strongly not to be persuaded by the non-bank members of the ISDA and others that the "commercial risk" of bona fide hedgers should be expanded to include all financial risk, e.g. entity-wide balance sheet risks only indirectly related at most to the price risks of the commodities covered under the position limit rule. The Commission does not define "commercial risk" among the new definitions it proposes (75696). In view of past petitions to expand the bona fide hedge exemption to cover balance sheet risks, e.g. of pension funds investing in commodity index funds, the Commission should consider defining "commercial risk".

As the Commission's explanation for the proposed rule states, "the intention of a hedge exemption is to enable a commercial entity to offset its price risk: it was never intended to facilitate taking on additional risk" (FR 75703). A problem in the Commission's proposed definition of "bona fide hedging exemption" is the orderly trading requirement for determining whether negligent trading results in a hedge that takes on additional risk, rather than offsetting enumerated price risks. "The Commission intends to consider whether a person knew or should have known, based on the information available at the time, he or she was engaging in the [negligent trading] conduct at issue" (FR 75705). During the era of open outcry and specialists matching buyers with sellers, the determination by the Commission of whether negligent trading had taken place, which would disqualify a person for the bona fide hedge exemption, sometimes may have been difficult.

During the era of Automated Trading Systems for commodity derivative contracts[10], this determination, using the traditional criterion of orderly trading, likely will become routinely difficult, posing an administrative burden on a Commission whose resources are under budgetary siege in a war of attrition.[11] While the Commission's non-exhaustive characterization of orderly trading has detailed and measurable parameters (FR 75705), one problem in applying the orderly trading criteria is whether "he or she" will be able to distinguish between information relevant to price formation and the "noise" generated by ATS algorithms responding to other algorithms. A definition of "negligent trading" that incorporates the "how" of trading technology employed by the person, and not simply a point in time determination of trading information interpreted by the person, is urgently required.

Spot Month Position Limits and the frequency of review of the Limits

IATP joins the CMOC in believing that the initial proposed Spot Month Position Limits for the 28 Core Referenced Futures Contracts are set too high to deter excessive speculation.[12] The proposed limits of 25 percent of estimated deliverable supply in the referenced contracts do not, as the CMOC letter notes, take into account the "unique production, supply and delivery features" of each covered commodity. In the case of agricultural commodities, climate change affected production and logistics (e.g. fifty percent loaded barges due to decreased river depth) has made estimated deliverable supply a less reliable estimate, notwithstanding the claims of precise forecasts by Big Ag Data firms. IATP hopes that the revised spot limits will not only be lower, but take into account the structural features of production supply and delivery for each of the Core Referenced Futures Contracts.

IATP supports the CMOC argument that existing computer technology makes it readily possible for traders to incorporate annually revised Spot Month Position Limits into their trading strategies and compliance supervision activities. However, IATP is sympathetic to a one-time only revision of initial Spot Month Position Limits in 2016 for the sake of ensuring that the cross border application of the position limit rule, as well as other provisions in the CFTC's cross-border guidance, are fully and expeditiously implemented in harmony with Over the Counter derivatives regulatory reforms in Group of 20 jurisdictions, particularly per the CFTC's "Path Forward" agreement with the European Commission.[13]

The European Union's revised Market in Financial Instruments Directive (MiFID 2), agreed on January 14, contains articles on position limits and position reporting that are mandated for implementation by EU member states by the end of 2015.[14] However, just as the Commission's position limit rulemaking has been delayed by the ISDA et al lawsuit, it is possible that a position limit regime in European Union jurisdictions likewise could be delayed by industry lawsuits. Delay could also occur as a result of litigation arising from EU member state deviations from the mandated European Securities and Markets Authority methodology for setting Limits on contracts traded on venues in their jurisdictions.[15] For the sake of an effective implementation of the Commission's cross-border guidance regarding position limits, a one-time only review of Spot Month Position in 2016 seems to us a prudent measure to allow both for the possibility of litigation forced delay and for the European Union member state regulators to set position limits based on robust and comprehensive position data and a transparent ESMA methodology. Thereafter, the Commission would review the market performance of Spot Month Position Limits in the 28 Core Referenced Futures Contracts annually to determine whether those limits needed to be revised and to determine whether other contracts needed to be added to the Core Referenced Futures Contracts.

Proposed Conditional Spot Month Position Limits

The Commission proposes to expand the Conditional Spot Month Limit from the covered natural gas contract in the 2011 proposed rule to apply to all 28 Core Referenced Contracts. The Conditional Spot Month Limit rule would allow investors in those Contracts to hold positions up to five times as great as the Spot Month Position Limits, i.e. 125 percent of estimated deliverable supply for cash settled only contracts, provided that they did not hold positions in the physically deliverable supply for the Contracts traded under the propose Conditional Spot Month Limit.

We join the CMOC in opposing the creation of what is in effect a vast position limits exemption for investors trading cash settled only contracts covered by the position limits rule. We agree with the CMOC that the Conditional Spot Month Limit exemption would result in diminished liquidity for bona fide hedgers, as investors migrate en masse to the far more permissive Conditional Spot Month

Position Limits for cash settled only contracts. The efficacy of the Spot Month Position Limits to prevent and diminish excessive speculation in the referenced contracts would be undermined by an overwhelming preponderance of investment in cash settled only contracts, including commodity index fund investing, that would occur to take advantage of the proposed Conditional Spot Month Position Limit.

Revision of the initial Spot Month Position Limits would not change the ratio defined disparity between physically deliverable and cash settled only contracts that this proposed exemption from Spot Month Positions Limits for investors in cash settled only contracts would create. The negative impact of this proposed exemption for bona fide commercial hedgers would be exacerbated by similar exemptions created in foreign jurisdictions. IATP urges the Commission to delete the proposed Conditional Spot Month Position Limit and replace it with a Conditional Spot Month Limit for cash settled only contracts that would have a one to one ratio with the initially proposed Spot Month Position Limits for physically deliverable contracts. The parity in limit ratios would foster adequate speculation in the Core Referenced Futures Contracts without restricting the liquidity required by bona fide commercial hedgers.

Conclusion

IATP greatly appreciates the Commission's diligence, persistence and courage in re-proposing the Position Limit Rule in the face of industry opposition to the rule and the possibility of future litigation to prevent promulgation of the rule. Our criticism of the proposed rulemaking notwithstanding, we look forward to working with the Commission to ensure that the Position Limit Rule and the rule on Aggregation of Positions are applied effectively both in U.S. markets and to persons covered by the cross border guidance to prevent, diminish and if possible, eliminate excessive speculation in commodity derivatives contracts.

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[1] http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2013-27200a.pdf

[2] IATP is a nonprofit, 501(c)(3) nongovernmental organization, headquartered in Minneapolis, Minn., with an office in Washington, D.C. Our mission states, "The Institute for Agriculture and Trade Policy works locally and globally at the intersection of policy and practice to ensure fair and sustainable food, farm and trade systems." To carry out this mission, as regards commodity market regulation, IATP has participated in the Commodity Markets Oversight Coalition (CMOC) since 2009, and the Derivatives Task Force of Americans for Financial Reform since 2010. IATP has submitted several comments on CFTC rulemaking, and on consultation papers of the International Organization of Securities Commissions, the European Securities and Markets Authority, and the European Commission's Directorate General for Internal Markets.

[3] http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=33809&SearchText=Institute%20for%20Agriculture%20and%20Trade%20Policy

[4] International Swaps and Derivatives Organization and Securities Industry and Financial Markets Association v. United States Commodity Futures Trading Commission, United States District Court for the District of Colombia, December 2, 2011, Case 1:11-cv-02146.

[5] http://www.financialstabilityboard.org/publications/r_140204.htm

[6] E.g. see the bibliography compiled by Markus Henn, "Evidence on the Negative Impact of Commodity Speculation by Academics, Analysts and Public Institutions," November 26, 2013, WEED. Available athttp://www2.weed-online.org/uploads/evidence_on_impact_of_commodity_speculation.pdf

[7] Benoit Guilleminot, Jean-Jacques Ohana and Steve Ohana, "The Interaction of Speculators and Index Investors in Agricultural Derivatives Contracts," March 18, 2013, revised December 30, 2013. Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2253374

[8] Gregory Meyer, "Commodity trackers flee for surging stocks," *Financial Times*, December 4, 2013.

[9] Gregory Meyer, "Commodity traders take aim at rule to limit speculation," *Financial Times*, February 9, 2014.

[10] E.g. David Bicchetti and Nicolas Maystre, "The synchronized and long-lasting change on commodity markets: evidence from high-frequency data," Munich Personal RePEc Archive, March 2012. http://mpra.ub.uni-7muenchen.de/37486

[11] Robert Schmidt and Silla Brush, "Budget Woes Leave U.S. Swaps Agency Outgunned by Wall Street", Bloomberg News, January 17, 2014.

[12] Commodity Markets Oversight Letter to the Commodity Futures Trading Commission on the "Notice of Proposed Rulemaking on Position Limits for Derivatives," February 10, 2014.

[13] "The European Commission and the CFTC Reach a Common Path Forward on Derivatives," Commodity Futures Trading Commission press release, July 11, 2013. http://www.cftc.gov/PressRoom/PressReleases/pr6640-13

[14] "Deal to regulate financial products and markets and curb high-frequency trading," European Parliament press release, January 14, 2014. http://www.europarl.europa.eu/news/en/news-room/content/20140110IPR32414/html/Deal-to-regulate-financial-markets-and-products-and-curb-high-frequency-trading

[15] MiFID 2 mandates the European Securities and Markets Authority to develop a methodology for EU member state authorities to set position limits in their jurisdictions. Paragraph 1008 (currently Article 59) of MiFID 2. MiFID will become official legislation following its translation into the 23 EU member state languages and a pro forma approval by a plenary of the European Parliament no later than April, at which EMSA's time limit (6-12 months, depending on the type of rule of standard) for developing mandated regulations and technical standards begins.