Position Limits Start to Bite

By Joanne Morrison

For more than a year politicians in Washington have demanded a crackdown on excessive speculation in the commodity futures markets and criticized the Commodity Futures Trading Commission for failing to prevent speculators from driving up prices for food and fuel.

Now the CFTC is responding. Under the leadership of Chairman Gary Gensler, who took office in May, the agency has taken several actions targeting specific market users and certain markets. Gensler also is considering broader changes, including tighter controls on exemptions and more direct involvement in the setting of position limits in the energy markets.

The activity is beginning to have an impact. Investors have pulled back from using commodity futures, reacting to both the actions taken by the CFTC and the potential for more to come. At least four funds have closed their doors to new investors to avoid exceeding position limits, and at least one fund has switched to using over-the-counter swaps instead of futures. These trends have fanned the fears of industry participants who warn that the crackdown will drive trading to less-regulated OTC markets or to overseas markets where there are no position limits.

In addition, CME Group has announced plans to set hard limits on the size of speculative positions in its energy futures. The move may head off more drastic action by Gensler, who is considering whether these limits should be set by the CFTC rather than the exchange. In this case, the pressure for change is not just coming from Congress. Some industry participants also are calling for the CFTC to exercise this authority, saying this would prevent exchanges from using position limits as barriers to competition.

CFTC Takes Action

During the presidential campaign last year, Barack Obama vowed to crack down on speculators. His choice for CFTC chairman is making good on that promise.

Under Gensler's direction, the CFTC held three days of hearings this summer to review all aspects of the agency's policies on position limits. During those hearings, Gensler made it clear that he wants to tighten the rules and asked for comment from the witnesses on how that should be done.

The range of options includes setting tighter limits on speculators, taking a less permissive view on exemptions, and extending position limits to over-the-counter markets and foreign boards of trade. The policy options also include shifting position limit setting to the CFTC from regulated exchanges. The CFTC already sets limits for futures on wheat, corn and certain other U.S. agricultural products, but delegates that authority to the exchanges with respect to all other commodity futures.

After the hearings, Gensler indicated that he is planning to propose new rules sometime this fall. In the meantime, the CFTC has taken several actions targeting speculative activity in specific areas.

In August the CFTC revoked two "no action" letters that had granted position limit exemptions to two companies: Gresham Investment Management, a New York-based asset manager for institutional investors, and DB Commodity Services, a subsidiary of Deutsche Bank that manages exchange-traded funds that track commodity indices. Those exemptions, which were granted in 2006, allowed the funds operated by the two companies to exceed the CFTC's position limits in corn, wheat and soybean futures.

"I believe that position limits should be consistently applied and vigorously enforced," Gensler said in a statement announcing the revocation of the two letters. "Position limits promote market integrity by guarding against concentrated positions."

Also in August, the CFTC set out tough new conditions for ICE Futures Europe, which trades crude oil contracts that settle to a price based on the WTI crude oil futures traded at the New York Mercantile Exchange. As a condition for continuing to provide U.S. customers with access to its products, ICE agreed to accept greater market surveillance by the CFTC and greater oversight of its rules. The move was the latest in a series of steps taken by the CFTC to extend U.S. regulations and oversight to the WTI futures traded on ICE, including the application of Nymex position limits to the ICE WTI contract starting in July 2008.

"The CFTC must ensure that U.S. commodity markets operate fairly and efficiently and are free from fraud, manipulation and other market abuses," Gensler said in announcing the new conditions. "Today's action further ensures that the CFTC has the tools necessary to carry out its surveillance and enforcement mission while promoting market integrity in the energy markets."

Thirdly, the CFTC implemented new rules mandated by Congress the previous year when it authorized the agency to regulate "significant price discovery contracts" that trade on exempt commercial markets. Under these rules, the CFTC in July required IntercontinentalExchange to apply position limits to its most heavily traded natural gas swaps that are comparable to the position limits that Nymex applies to its natural gas futures.

Reaction in the Marketplace

All the regulatory scrutiny has indeed had an impact. Managers of exchange-traded funds and notes that are designed to track commodity prices have been halting new share issues in anticipation that new position limits could limit the number of futures contracts they can buy. In addition, institutional fund managers are worried that they will lose exemptions needed to establish big positions for pension funds and other institutional investors.

A dramatic response came from United States Natural Gas Fund, the world's largest exchange-traded fund that invests in natural gas futures. Driven by investor demand, this fund had owned more than 30% of the outstanding gas futures contracts in the U.S., according to analysts. But in August, responding to regulatory uncertainty over speculation limits, the fund announced a temporary moratorium on new investors. The fund also

reduced its reliance on the futures markets by entering into two over-the-counter swap transactions with a combined value of $750 million.

John Hyland, the fund's chief investment officer, said that entering into these alternative transactions was an attempt to deal with possible new regulations.

During testimony at the CFTC's position limits hearings, Hyland said that the funds' activities in the futures markets have resulted in little or no price disruption even as the overall size of the fund's positions have increased.

"Instead of disrupting the futures market, the funds provide a steadying force by adding significant liquidity to the market," Hyland said. He also stressed that the funds are used by hundreds of thousands of retail investors to gain access to the commodity futures markets, and argued that applying position limits to UNG only serves to displace that investment activity into other funds.

The Aug. 12 suspension of new shares at UNG has led to a surge of investor inflows into a European alternative, Natural Gas ETC, a fund managed by ETF Securities that has seen the total value of assets invested double in less than a month's time.

Deutsche Bank, as a result of the CFTC rescinding its no-action letter, has until Oct. 31 to bring its exchange-traded funds into compliance with the position limits. Deutsche Bank also announced on Sept. 1 that it would redeem all $425 million in its leveraged oil exchange-traded notes in response not only to possible new position limits but a warning issued by the Securities and Exchange Commission about the risk of leveraged ETFs.

Another example of a fund affected by the CFTC clampdown is the iShares S&P GSCI Commodity Index Trust, a $1.6 billion fund managed by Barclays Global Investors that uses commodity futures to track the GSCI index. On Aug. 24, BGI stopped selling new shares in the fund because of the uncertainty surrounding position limits and warned its investors that this could cause shares to trade at a premium or discount to net asset value. The fund has been operating under a hedge exemption granted by the CME that is set to expire at the end of the year, according to a regulatory filing.

"We've taken this temporary step to protect existing investors from being adversely affected by market reaction to proposed new regulations of commodity futures that have created uncertainty," Michael Latham, co-chief executive officer of BGI's iShares division, said in a statement.

All of these funds are designed for retail investors; their shares trade on exchanges and they are required by the SEC's rules to disclose material changes to their investment portfolios. The impact of the CFTC's clampdown on institutional investors has been less visible. This is partly because institutional investors have the ability to use over-the-counter swaps to diversify their portfolios. Because these are not traded on an exchange, they are not subject to position limits. On the other hand, Gensler has questioned the ability of swap dealers to obtain exemptions from position limits, which would limit their ability to lay off risk. If swap dealers lose some of their ability to write these commodity swaps, that would have a direct impact on the ability of institutional investors to access these markets.

CME's Hard Limits Plan

On Sept. 16, CME issued a set of recommendations to address the controversy over position limits. CME proposed that energy futures exchanges should apply hard limits to speculative positions in each contract month and all months combined. Currently CME only applies hard limits during the last three days before expiration. At all other times the exchange relies on accountability levels, which serve as a warning signal to the exchange's surveillance staff when a market participant's position exceeds a certain level.

CME also proposed that exchanges should be responsible for administering hedge exemptions for eligible market participants, while the CFTC would have the authority to impose aggregate position limits on the OTC derivatives markets. CME warned, however, that if the changes are not applied across all energy markets in a synchronized way, trading very likely would migrate to whatever venue remained outside the CFTC's oversight.

"We recognize that misperceptions can undermine confidence in well-functioning markets, which is why we support the CFTC's mission to provide regulatory certainty and to ensure that the energy markets can operate efficiently," Terry Duffy, the exchange's executive chairman, said in a statement. "Imposing hard limits on energy products must be delicately balanced with the need to ensure that such limits do not have a detrimental effect on the markets. We cannot and should not force market participants away from the best regulated markets to less regulated or even unregulated markets and dark pools of opaque transactions."

ICE Pushes CFTC Role

IntercontinentalExchange, which offers competing contracts in both natural gas and crude oil, called the CME plan "flawed" and reiterated its stance that any new position limit or accountability level regime must be administered by the CFTC.

"The CFTC has the experience, systems, and increasingly, the budget to administer this type of regime more broadly," ICE said in a Sept. 17 statement. "Only the CFTC can and will have broad and regular access to all position data regardless of venue and is therefore uniquely able to determine compliance with limits and appropriateness of exemptions."

ICE also argued that the imposition of position limits and accountability levels "should promote competition and customer choice by being market and exchange agnostic." CME's plan, which recommends setting position limits as a percentage of an exchange's open interest, would make it harder for smaller exchanges to build liquidity, ICE asserted.

Competition Concerns

While Gensler is pushing forward on position limits, it is not clear how much support he has enlisted from the other CFTC commissioners. Two of the four—Michael Dunn and Jill Sommers—have raised concerns about driving trading to OTC markets or to less-regulated offshore markets. Both Dunn and Sommers have said such a migration would hurt the regulated U.S. futures markets and

also undermine the broader goal of migrating standardized OTC derivatives to centralized trading and clearing.

"When a contract trades globally, it may be detrimental to U.S. markets for the CFTC to act unilaterally on position limits while other countries with benchmark contracts chart different courses," CFTC Commissioner Michael Dunn told *Futures Industry*. "There must be regulatory coordination internationally for position limits to be effective in global markets such as oil."

CFTC Commissioner Jill Sommers has cautioned that setting onerous position limits could actually "have the perverse effect of driving large portions of the market away from centralized trading and clearing at the very same time we are urging all standardized OTC activities be traded on-exchange or cleared."

Despite these concerns, the CFTC continues to come under pressure from Congress. While the recent spate of actions has drawn some praise, some lawmakers are demanding more. On Sept. 9, a group of 20 members of the House of Representatives called on the CFTC to implement new rules to safeguard the public from financial speculators "who are artificially inflating the price of oil." The lawmakers specifically requested the CFTC impose strict aggregate position limits across all energy products for all index traders, swap dealers and proprietary traders.

"For far too long, the American people have been forced to pay artificially inflated prices for gas and other oil products because greedy financial speculators have gamed the energy markets for their own profits," wrote Representative Maurice Hinchey (D-N.Y.), one of the leaders of the group. "At a time when so many families in New York and across the country are trying to get by in very difficult economic times, the last thing they need is to be forced to pay higher prices at the pump because a multimillionaire oil speculator is trying to become a billionaire."

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CFTC Provides More Transparency in Commodity Futures Markets

Responding to controversy over the role of swap dealers and index investors in the commodity futures markets, the Commodity Futures Trading Commission has begun providing more detailed information about the types of companies active in these markets.

In September, the CFTC began releasing an expanded version of its weekly commitments of trader reports that breaks out positions held by swap dealers and hedge funds. The agency also plans to release data on a quarterly basis that has been collected from swap dealers and index traders in the futures markets.

"A core mission of the CFTC is to promote market transparency," CFTC Chairman Gary Gensler said in announcing the new reports. "We are constantly looking for ways to improve our transparency efforts to best serve the American public. We will continue to update the processes by which we report data to the public and market participants with a goal of promoting market transparency."

For decades, the CFTC has provided the futures industry with COT reports consisting of aggregated data on open interest. These reports are intended to shed light on the changing composition in the markets and have been required by law since the 1920s. But over time these reports have been modified and expanded. In 2007, for example, they were expanded to include weekly commodity index information for 12 agricultural markets.

Previously the COT reports divided traders into two broad categories: commercial and noncommercial. The new COT reports now include a more detailed breakdown into four categories of traders: producer/merchant/processor/user; swap dealers; managed money; and other. The additional information is provided for 22 contract markets, including major agriculture, energy and metals markets.

The CFTC still plans to continue to release the traditional COT reports for a transition period at least through the end of 2009. In addition, the agency is working on releasing three years of historical trader information based upon the new reporting. "This will allow the public to become familiar with the new reports as well as comment to the CFTC as to any future possible enhancements," the agency said.

The CFTC is also considering changes to the reports that cover financial markets to "improve the accuracy of trader classifications," the agency said.

Index Investment Data

In addition to providing more details in the weekly COT reports, the CFTC will begin providing quarterly information on index investment in the futures markets, with plans ultimately to release this data on a monthly basis. This new data will include both gross long and gross short positions and will update data released in a special report last September.

Responding to concerns among policymakers that excessive speculation helped cause a surge in commodity prices, the CFTC last year issued 43 "special call" requests for details of market positions association with physical commodity futures, including index investment activities. Among those requests, 16 were directed to large swap dealers and 14 were directed to commodity index funds, including asset managers of exchange traded funds.

The new data is complied from information gathered from all the swap dealers and index fund—namely every swap dealer that has been granted an exemption from speculative position limits for their index investment activities and two entities that had received no-action letters allowing them to exceed such limits to operate commodity-based index investment strategies.—*Joanne Morrison*