CFTC Examines Position Limits

By Will Acworth

In late July and early August the Commodity Futures Trading Commission held three days of hearings on the use of position limits to limit excessive speculation in the commodity futures markets. The CFTC heard a broad range of views from representatives of industrial energy consumers, airlines, utilities, financial institutions, fund managers, members of Congress, academics and trade associations.

The hearings examined a number of policy issues. Participants debated whether the CFTC is required to set position limits, whether the limits should be set by exchanges or regulators, and what sorts of information should be used in determining position limit sizes. Participants also discussed whether exemptions should be granted to market participants that are trading futures as a hedge, and whether such exemptions should be granted to financial institutions acting as intermediaries. Perhaps most importantly, participants debated whether the stricter application of position limits would drive trading into less regulated markets.

The CFTC also heard conflicting views on the impact of speculation on commodity prices. Representatives of energy-intensive companies such as the American Trucking Association blamed excessive speculation for the increase in oil and natural gas prices and urged the CFTC to apply position limits to all speculative market participants and reduce or eliminate exemptions to those limits. Countering this view, several financial institutions and fund managers emphasized the role of speculation in providing liquidity to the futures markets. In addition, several commercial hedgers urged the CFTC to avoid limiting the ability of swap dealers to use the commodity futures markets.

Philip Verleger, an oil market expert and former U.S. government official now teaching at the University of Calgary, offered an alternative explanation of the volatility in crude oil prices. Verleger discounted the influence of speculators and pointed instead to a variety of fundamental causes, including the impact of environmental regulations that have increased the demand for sweet grades of crude. Verleger also argued that passive investors in the commodity futures markets have tended to act as buffers, stabilizing prices rather than making them more volatile.

Concern about Concentration

During the course of the hearings, CFTC Chairman Gary Gensler made several comments suggesting that he believes the CFTC should exercise its authority to set position limits. "No longer must we debate the issue of whether or not to set position limits," he said. "I think it's more a question of how than whether." Gensler explained that the CFTC is required by statute to apply position limits to prevent "undue burdens" caused by excessive speculation, and questioned why the CFTC sets position limits in certain agricultural futures contracts but leaves it to the exchanges to set limits in the energy markets.

Gensler also raised a related concern about market concentration. In explaining why he thought the CFTC should set position limits, he said they could be used to "enhance liquidity" by promoting more market participation and preventing the markets from being dominated by a handful of large institutions.

"I believe that at the core of promoting market integrity is ensuring markets do not become too concentrated," Gensler said. "This is even more relevant today because financial markets have become more concentrated since the first exemptions were allowed in 1991 and the position accountability level regime was first implemented. The financial crisis highlighted the risk to the market and to the American public brought about by large concentrated actors on the financial stage."

Before the CFTC can act, however, Gensler will need supporting votes from the three other CFTC commissioners, and the hearings indicated that at least two of those commissioners have some reservations. Commissioner Dunn, a Democrat who served as the acting chairman for several months before Gensler took office, cautioned that tightening restrictions on the futures markets might drive trading into other markets outside the CFTC's reach.

"Without similar steps in the OTC markets and on foreign boards of trade, those seeking to evade the limits we set could simply move to venues outside our authority," Dunn warned in his closing statement. Jill Sommers, the only Republican commissioner, also raised this concern, repeatedly asking witnesses about the potential for migration of trading to markets outside the CFTC's jurisdiction.

CME Announces Hard Limits

Craig Donohue, chief executive officer of the CME Group, urged the CFTC to resist pressure from politicians and consumers angered by the rise in fuel prices. The CFTC cannot control prices through position limits, he warned, and if they are not applied correctly they "can easily distort markets, increase the costs to hedgers and effectively increase costs to consumers." Donohue did announce, however, that CME will address concerns about speculation by setting "hard limits" on the size of speculative positions in

the energy futures traded on its New York Mercantile Exchange subsidiary. Those markets currently have position limits only in the last three days of trading before expiration. Donohue's announcement effectively means that the Nymex accountability levels, which trigger heightened surveillance, will be replaced by position limits.

Jeffrey Sprecher, chief executive officer of IntercontinentalExchange, agreed with Donohue on the dangers of giving in to political pressure. "During times that unpopular price signals are being sent by markets, it is often tempting for policy makers to take proactive steps to address what they perceive to be structural problems in the market," Sprecher said. "While well intentioned, these measures often fail to achieve their desired objectives or, worse yet, lead to unintended consequences such as increased price volatility and distortion of important price signals that would otherwise be discovered in properly operating markets."

On the position limit question, however, Sprecher took a very different view, arguing that it should be the CFTC, not the exchanges, that set position limits, accountability levels and hedge exemptions. Sprecher pointed out that under the current regulatory structure, position limits and accountability levels set by Nymex for its energy futures apply to ICE contracts that are linked to the settlement price of those Nymex futures. As a result, "ICE is beholden to position limits and hedge exemptions determined by its competitor," he said, a situation that is "rife with potential conflicts of interest." Sprecher therefore argued that the CFTC, as a neutral party, should administer the position limit and hedge exemption regimes.

FIA Warns on Market Migration

Testifying on behalf of the FIA, Mark Young, a partner in the Washington office of Kirkland and Ellis, urged the CFTC to consider the risk of "market migration" if it applies restrictive position limits. "Repeatedly we are told by our members, in the most emphatic terms, that futures markets and their inherent price discovery function are moveable," Young told the CFTC. Imposing a "rigid, inflexible position limit solely on U.S. futures trading" could cause traders and hedgers to shift to other venues such as OTC derivatives, spot market transactions or foreign exchanges, he warned. That would be a problem not only for the U.S. futures markets but also for the CFTC, which would find it more difficult to oversee the price discovery process.

Young also reiterated the FIA's view that the CFTC should preserve the position limit exemptions for swap dealers that use futures to hedge risks in their OTC swap positions. "Dealers that act as risk aggregators for OTC positions and then lay off residual price risk in the futures markets fit well within the traditional concept of a price risk-offsetting hedger," Young said.

Young did express support for legislation establishing the CFTC's standby authority to impose limits on positions taken by U.S. market users in OTC or foreign markets if those positions are settled against prices of futures contracts traded on U.S. exchanges. This authority should be used sparingly, Young said, and only on the basis of reasoned and balanced analysis. Young said the FIA also supports legislation to enhance the transparency of OTC derivatives market activity and urged the CFTC to regularize its requests for position information from swap dealers and investment managers. Through this regular data, the CFTC could also make its Commitments of Traders reports more granular in terms of the aggregate positions, net long and net short, held by swaps dealers and index traders, he pointed out.

The CFTC also heard testimony from representatives of two leading swaps dealers—Blythe Masters, managing director and head of the global commodities group at J.P. Morgan, and Donald Casturo, managing director at Goldman Sachs. They both recommended that position limits should be imposed on end users and not on the firms conducting transactions on behalf of their customers. "We are not asking for special treatment other than when we are facilitating business for others," said Masters. "Our position is, where we are acting in our own proprietary capacity, we should be subjected to position limits."

Impact on ETFs

Though the CFTC has not yet overhauled its rules on position limits, the change in orientation has already begun to affect trading decisions in the energy markets. The United States Natural Gas Fund, an exchange-traded fund that invests in natural gas futures and swaps, announced on Aug. 11 that it will suspend offering new shares out of the concern that tighter position limits will prevent it from meeting its investment objectives.

The fund, which trades under the symbol UNG, said in a regulatory filing that it would not issue any new shares and might even reduce its size "due to current and anticipated new regulatory restrictions and limitations" imposed by the CFTC, Nymex and ICE. The UNG announcement came after the CFTC determined that the ICE natural gas swap was a "significant price discovery contract." This triggered a requirement that ICE apply position limits to this contract that are comparable to the existing Nymex position limits on its natural gas futures.

"While it cannot be predicted at this time what regulatory restrictions and limitations will eventually be imposed or how they will impact UNG, if any of the aforementioned items are implemented, UNG's ability to meet its investment objective may be negatively impacted and investors could be adversely affected," the company said in the filing.

As of Aug. 12, the fund held more than $4 billion in assets under management. Its investments included 28,351 NYMEX front-month natural gas futures, 287,284 ICE natural gas swaps based on the Nymex futures settlement price and 51,746 NYMEX front-month natural gas swaps. Both swaps contracts are one-fourth the size of the futures in terms of notional value.

In July UNG bought a $250 million over-the-counter natural gas swap as an alternative way to gain exposure to natural gas prices without violating position limits. The fund warned in the Aug. 11 filing, however, that switching to swaps could result in higher costs and increased tracking error relative to the benchmark futures prices.

CFTC Withdraws No-Action Letters

In another action related to position limits, the CFTC on Aug. 15 withdrew "no-action" letters that allowed two fund managers to exceed its position limits in the corn, wheat and soybean futures markets. The letters had been granted several years ago to Gresham Investment Management, a New York money manager, and DB Commodity Service, a subsidiary of Deutsche Bank that manages several exchange-traded funds that track commodity indices. In both cases the CFTC provided the fund managers with time to bring their positions within the limits, although Gresham officials indicated that its holdings were below the limits. n

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