21 January, 2011

Mr. David Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street NW
Washington, DC 20581

Re: Position Limits

Introduction

1. As a scholar who has followed, and has contributed to, the debate over speculation in commodity markets, I am grateful to have this opportunity to comment on the Commission's Notice of Proposed Rulemaking (NOPR) on Position Limits in Derivatives issued on 13 January, 2011.

2. I am Professor of Finance and Energy Markets Director of the Global Energy Management Institute at the Bauer College of Business of the University of Houston. I have been involved as a practitioner and academic in the futures and derivatives markets since 1986. During that quarter-century, I have conducted and published substantial research on all major commodity sectors, and on the issues related to speculation and speculative position limits. In particular, I have published a book and eight articles on the economics, law, and public policy of market manipulation. I have also written articles on the behavior of commodity prices; this research bears on the issue of whether speculation has distorted commodity prices. My new book, *Structural Models of Commodity Prices*, will be published in the spring of 2011: this book specifically examines evidence related to the effect of speculation on commodity price behavior. In 2008, I testified at hearings before the House Committee on Agriculture on the effects of speculation on energy prices.

3. In addition to my academic research, I have served as a consultant to major futures exchanges around the world on issues related to contract design, contract performance, and market manipulation. For instance, I was on the Grain Delivery Task Force that re-designed the Chicago Board of Trade's corn and soybean futures contracts in 1997. I have also served as an expert witness in a variety of cases involving energy, agricultural, and metals derivatives, including cases on commodity market manipulation.

4. I have reviewed in detail the Commission's NOPR. Based on this review, I conclude that the Commission's rule is fundamentally flawed, and should be withdrawn. It is fundamentally flawed because it is far too expansive. It will constrain severely trading activity that poses none of the dangers that the Commission has identified in the NOPR. It will impair unnecessarily liquidity in the over-the-counter (OTC) derivatives markets, thereby burdening legitimate speculators, investors, and hedgers. Moreover, there are serious logical inconsistencies in the spot-month limits the Commission proposes.

5. The legitimate policy objectives that the Commission has identified can be achieved without burdening legitimate trading activity as its proposed rule would. In particular, a position accountability regime would target the specific threats that certain kinds of speculative activity can sometimes present without limiting legitimate and beneficial speculative activity.

All-Month Limits Are Over-Inclusive, and Unnecessarily and Inefficiently Restrict Legitimate Trading Activity

6. Any policy should be predicated on a clear identification of the inefficiency that it is intended to ameliorate. Moreover, the policy should be designed to address that specific inefficiency in a way that does not inflict collateral damage on legitimate and beneficial conduct.

7. To its credit, the Commission has identified two ways in which speculation by large traders might destabilize futures markets. First, the Commission states "[l]arge concentrated positions in the physical commodity markets can potentially facilitate price distortions given that the capacity of any market to absorb the establishment and liquidation of large positions in an orderly market is related to the size of such positions relative to the market and the market's structure." The Commission suggests that the concern arises most acutely in markets dominated by a few players who do not trade independently of one another, using different trading strategies. It uses the Hunt position in silver in 1979-1980 as an example of what can happen as a result in such circumstances. Second, the Commission avers that large positions taken by levered traders can create systemic risks.

8. These are real concerns; indeed, I have written about the Hunt case specifically and the potential systemic risk posed by levered players generally. It should be noted, however, that these concerns are not unrelated. Sudden liquidations that could be destabilizing are most likely to occur when large, levered traders suffer substantial losses.[1] This is what happened with the Hunts in 1980. They had borrowed heavily to finance their trading in silver, and many of their loans were collateralized using silver. As the price of silver declined, the Hunts had insufficient ready cash to support their borrowing, and this forced them to search for ways to reduce their silver positions. Thus, single, large, levered traders

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[1] These losses can be on their large speculative derivatives positions, or on other investments or trading positions.

should be the focus of the Commission's efforts to constrain potentially destabilizing speculative activity.

9. These real concerns do not justify, however, the sweeping restrictions that the Commission has proposed. Most importantly, the regulations are vastly over-inclusive. The proposed limits will apply to many traders that are not highly levered, or who are not levered at all. Moreover, they apply to some funds that mechanically invest monies provided by large numbers of individuals making their own individual trading decisions. In addition, the limits apply to some markets that pose absolutely no systemic risk whatsoever. Furthermore, there are other less disruptive and less restrictive means to mitigate the problems identified by the Commission. For all these reasons, the Commission's proposal is fundamentally flawed, and should be withdrawn and replaced by regulations that target more precisely the specific dangers the Commission has identified.

10. The proposed position limits can potentially constrain the size of entities that do not pose the threats that the Commission has identified. These constraints may be direct or indirect. The limits can directly restrict the size of these entities because absent the limits, some of these (unthreatening) entities would establish positions in excess of the speculative limit. The limits can indirectly restrict the size of these entities by constraining the ability of intermediaries through whom some of these entities trade (most notably swap dealers) to supply liquidity. Lower liquidity means higher costs, and some entities will establish smaller positions due to these higher costs. The proposed aggregation rules may also constrain the operations of entities that do not raise concerns of the type the Commission has used to justify its imposition of limits.

11. As a particular, and important, example, the limits would apply to exchange-traded funds (ETFs). Many ETFs are not leveraged; the largest ones that would be most likely to be constrained by the limits are not. Moreover, although the funds themselves can be large, they mechanically buy or sell futures contracts based on investments of funds or withdrawals of funds by large numbers of individual investors acting independently. Some of the cash provided by ETF investors is used to pay margins on futures, and the remainder is typically invested in Treasury securities, cash, or cash equivalents. Since (a) these funds are not levered, and are in fact 100 percent collateralized, and (b) the buying and selling of futures by the ETF managers is determined solely by the decisions of large numbers of individuals acting independently, unlevered ETFs pose neither of the hazards the Commission identifies.

12. The trading of even levered ETFs is determined by the decisions of large numbers of independent actors, and thus does not pose any greater risk than would exist if these same traders levered themselves, and bought and sold directly rather than *via* the ETF. Thus, most ETFs do not result in the combination high leverage and a lack of independent decision-making that worries the commission. Many ETFs, including the largest and most important, do not result in either.

13. Restricting directly or indirectly the positions that ETFs can hold imposes costs on market participants. ETFs can exploit scale economies, and they may also be subject to scale diseconomies. Restricting ETFs to sizes that do not realize fully available scale economies inflates the costs that individuals incur to trade on the derivatives markets. These additional costs do not result in any corresponding benefit under the Commission's theories of how speculation can potentially destabilize markets. It is preferable that the process of market competition determine the sizes of ETFs, and whether individuals choose to trade on commodity derivatives markets *via* ETFs or individual accounts held at FCMs. Market competition will tend to cause funds to operate at their efficient scale, thereby ensuring that investors who desire to use these funds to achieve investment objectives (including return, diversification, exposure to specific risks) can do so in the most economical way.

14. ETFs are not the only entities who (a) may be constrained directly or indirectly by the proposed limits and (b) do not pose the dangers identified by the Commission. In recent years pension funds and other "real money" investors have diversified into commodities, particularly *via* commodity index products. These are not levered investors, and generally have long-term investment horizons and do not buy or sell in a way that poses a threat to destabilize the market in ways that the Commission has identified. Moreover, these entities can achieve real benefits through participation in commodity markets, most notably diversification that improves the risk-return performance of their portfolios. Their participation also serves to integrate commodity markets with the broader financial markets. This is beneficial because it ensures that risks are priced and distributed properly and consistently across all investment and trading opportunities.

15. Rather than mandating a position limit regime that imposes costly constraints on entities that pose no threat of the kinds identified by the Commission, it would be preferable to rely on alternatives that are directly responsive to the Commission's specific concerns. For instance, accountability level-type systems can identify large positions, thereby permitting a more detailed determination of whether a holder of such a position is a single entity, or a levered entity, or especially a single levered entity who would pose the kind of disorderly liquidation threat that the Commission highlights. Based on such information, it would be possible for the commission, or a self-regulatory entity operating subject to the Commission's regulations, to take action targeted to the actual threat posed—if any. It is important, moreover, that any such discretionary actions be constructed so as to reduce in a reasonable way a real threat of market disruption without demoralizing legitimate trading, and that the system give the affected parties some recourse to challenge any decision (e.g., an order to reduce positions) that is unreasonable, or for which the Commission or self-regulatory body has not provided a factual foundation demonstrating that the position in question actually threatens market stability.

16. The Commission argues that "[c]oncentration of large positions in one or a few traders' accounts can also create the unwarranted appearance of appreciable

liquidity and market depth which, in fact, may not exist." This concern seems, no pun intended, to be more speculative than the Commission's other rationales for position limits. Moreover, even granting the legitimacy of this concern, there are remedies that are less onerous than position limits. Disclosure of information about concentration levels, and the sizes of largest positions, would make market participants aware of whether interest in a particular futures contract is widely dispersed or highly concentrated. Based on this information, there would be little or no risk that traders would be unaware of the potential for a large trader to liquidate a substantial position. There would also be little or no risk that traders would establish positions in the expectation that they would be able to liquidate these positions quickly as needed, only to find themselves unable to do so because the market was less liquid or deep than anticipated due to concentration on the *contra* side of the market.

17. The Commission already makes available concentration information in its Commitment of Traders Reports, and a refinement of this information would address the "unwarranted appearance" concern. Refinements could include: (a) reporting concentration by individual contract month, or subsets of contract months (as opposed to the reporting of concentration across all months as at present), (b) reporting concentration more frequently and in a more timely way, and (c) reporting broader measures of concentration, such as Herfindahl indices that can assist market participants in determining whether large positions are held predominately by one or two entities, or spread across four or eight in relatively equal shares.

18. The proposed limits are also an over-inclusive way to address Commission's concerns about systemic risk. The level of systemic risk is related more to the size of a position relative to the broader financial market rather than relative to the size of that position to the particular commodity in which the position is held. Moreover, it depends on the nature of the entity holding that position, and perhaps the nature of other entities holding positions in the same commodity: some entities are systemically unimportant, and their failure, although unpleasant to their owners, does not justify intervention.

19. The Commission's proposed limits would apply to a variety of commodity markets that are small and systemically irrelevant. Perhaps—perhaps—a commodity market such as crude oil or gold is large enough that the failure of an entity holding 2.5 percent-10 percent of its open interest could pose a threat to the broader financial system. Certainly the same thing cannot be said of most of the markets subject to the proposed limits, e.g., sugar, milk or palladium.

20. Even granting the possible benefits of position limits in a relatively rare set of circumstances, the Commission has provided virtually no justification for the size of the proposed limits. At most, a trader could hold 10 percent of open interest, but for larger markets the position would be limited to somewhat more than 2.5 percent of open interest. (The maximum position approaches 2.5 percent of open interest in the limit as open interest rises to an arbitrarily large level.)

21. The Commission provides no evidence or justification that these limits are necessary or reasonably appropriate to mitigate the specific risks that it has identified, and which it uses to justify the imposition of limits. The one historical example that the Commission points to—the Hunt silver trading in 1979-1980—provides some context. At the end of August, 1979, the Hunts and related parties held 27 percent of open interest for the December, 1979-May 1980 COMEX and CBOT silver futures contracts.[2] This is an order of magnitude larger than the smallest level proposed by the Commission, and more than 2.5 times the largest percentage limit.[3] The Commission has provided no evidence that the limits it has proposed are necessary to reduce the Hunt-like risk that the Commission uses as a justification for its limits. Since liquidity and systemic risk vary by commodity, moreover, one-size-fits-all limits do not reflect economically relevant differences between commodities.

The Definition of *Bona Fide* Hedging and the Within-Class Limits Inefficiently Constrain Liquidity and Increase the Likelihood of Large Price Moves

22. As required by statute the Commission's proposal restricts *bona fide* hedge exemptions from the limits to those trading derivatives as a substitute for an actual cash market transaction to be undertaken later, or those trading as the counterparty to an entity that is engaged in such a transaction. As an example of the latter, a swap dealer trading with a grain merchant or airline that sells or buys an OTC derivative as a hedge could claim for itself an exemption from the limits for that trade.

23. This definition of the hedge exemption is restrictive, and when combined with the class-based limits in the Commissions proposal will impose unnecessary and costly burdens on the operation of derivatives markets. In particular, this combination will raise the costs of market making and thereby damage liquidity and depth, and make it costlier for market participants to hedge.

24. For the purpose of calculating some limits, the Commission's proposal nets long and short positions across positions in futures (the "futures class") and OTC derivatives (the "OTC class"). However, the proposal also imposes limits on the individual classes, on an all-months and individual-months basis. These individual class limits unnecessarily and inefficiently constrain the operations of OTC market makers ("swap dealers.")

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[2] Jeffrey Williams, Manipulation on Trial, at 32.

[3] Although the Commission does not explicitly mention it, Amaranth Advisors LLC is another large speculator that is often mentioned as an example of the dangers implicit in concentrated positions. According to Table 9 in the report *Excessive Speculation in the Natural Gas Market*, produced by the Senate Permanent Subcommittee on Investigations of the Committee of Homeland Security and Government Affairs, in April, 2006 Amaranth held substantially more than 10 percent of the open interest for NYMEX natural gas contracts expiring in June, 2006-January 2007. Indeed, its holdings exceeded 25 percent of open interest for six contracts expiring during that period. Amaranth was also a highly leveraged trader, with a gearing ratio in excess of 5.

25. For instance, consider a market in which the position limit is 100 contracts. A market maker who is long 150 OTC contracts, and short 150 futures (across all months, or in the same month) would be net flat, and hence in compliance with the all-months all-class limit. However, this market maker would be in violation of the OTC class and futures class limits.

26. Although trades with *bona fide* hedgers would not count towards the limits, all other trades would. For instance, a swap dealer's trades with pension funds who desire to diversify into commodities would count against the limits. Similarly, a swap dealer's trades with legitimate speculators who are (a) providing liquidity and risk bearing capacity to the market, and (b) must themselves comply with the position limit requirement, would also count towards the swap dealer's limit. These are legitimate economic transactions that advance the economic purposes of the derivatives markets—risk transfer and price discovery. These transactions transfer risk to the swap dealer, but the limits constrain the dealer's ability to manage this risk by undertaking offsetting transactions in the futures market.

27. Since the within-class limits constrain the ability of swap dealers (and intermediaries/market makers generally) to hedge the risks of acting as counterparties to legitimate investors and speculators, the proposed limits almost certainly will limit the size of the positions that any swap dealer/market maker will be willing to hold and the amount of liquidity it will be willing to supply to the OTC market. Thus, the within-class limits will raise the costs that swap dealers incur to supply liquidity to the OTC derivatives markets.

28. Although the constraints imposed upon individual dealers may provide an opportunity for additional dealers to enter the market, or for smaller dealers to expand their positions, such responses would reflect an inefficient fragmentation of liquidity supply that is driven solely by an artificial constraint, rather than legitimate economic considerations.

29. There are economies of scale in market making, and position limits that prevent the realization of such scale economies raise the costs that market participants incur. Moreover, some market participants are better capitalized, and/or have better trading and risk management expertise, and/or have some other attributes that make them more attractive or efficient counterparties. These entities should be larger, and position limits may prevent these more efficient intermediaries from realizing their inherent efficiencies. This too would inflate costs that legitimate market users incur in pursuit of legitimate trading and investment strategies. These elevated costs will impair market liquidity, and harm both speculators and hedgers.

30. In essence, these limits serve as an implicit tax on the OTC commodity derivatives markets. In its proposal the CFTC identifies no economic purpose for such a restriction/tax. In particular, restrictions on OTC market making do not address concerns about sudden liquidations or systemic risk. These problems are associated with the holders of large net positions, so the within-class limits that do

not net across class are not necessary to address them. Moreover, the Commission provides neither evidence or argument that relates the within-class limits to the dangers of speculation that it identifies.

31. To the extent that the position limits impair the ability of market participants to supply liquidity to the OTC market, they would actually make the market more vulnerable to disruption and sudden price moves in response to large trades or economic shocks. The market would be more vulnerable because the limits would constrain market makers' ability to accommodate a sudden increase in the demand for liquidity. The more limited the supply response, the greater the price response to that shock

32. In order to eliminate the possibility that limits will uneconomically impede market making in OTC derivatives, the Commission should eliminate the within-class limits and enforce position limits on the basis of net positions across classes in order to permit swaps dealers and other OTC market makers to offset the risks inherent in a trade with any counterparty, thereby permitting the efficient supply of liquidity to the OTC market.

The Limits on Derivatives Positions Will Drive Some Participants Into the Cash Market in Ways That Can Distort Prices

33. The Commission should also avoid imposing limits that are so restrictive that they result in unintended consequences that are contrary to their ostensible purpose. In particular, it is almost certain that imposing limits on the derivatives positions that ETFs can hold will lead to the creation of physical-based ETFs that are not subject to position limits on derivatives. Indeed, such funds have already been created, and more are in the process of being created.

34. Some investors trade ETFs because they want to have exposure to commodity prices for diversification, investment, or speculative purposes. Derivatives-based ETFs allow the creation of effectively unlimited exposures without requiring the funds themselves, or the investors who buy them, to own or handle the underlying physical commodity. In essence, the commodity price exposure investors desire is unbundled from the physical commodity. This means that the amount of exposure that investors can achieve is not constrained by the supply of the physical commodity, and that investors' demand for exposure need have no impact on the demand for physical stocks.

35. The desirable flexibility inherent in this unbundling is lost if position limits raise the costs of achieving exposures *via* derivative-based ETFs, and in response to these higher costs investors choose to trade physical-based ETFs instead. [4]

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[4] It is not unprecedented for restrictions on derivatives trading to cause market participants to shift their trading to the physical markets. Notably, during the Hunt silver episode highlighted by the Commission, position limits and other restrictions imposed on the trading of silver futures was one factor that led the

36. This poses greater risks of disruption of prices in the physical market. With physical ETFs, there is a tension between the objectives of investors seeking commodity price exposure and the optimal production, consumption, and storage of the physical material. For instance, investors may desire to hold onto inventory of a commodity in order to achieve their broader portfolio objectives (e.g., diversification) when fundamental conditions in the marketplace would otherwise lead to a drawdown in stocks (to meet a demand shock, for instance). This could cause prices to react more violently to fundamental shocks because inventories do not adjust to buffer the effects of these shocks on prices as they would in the absence of investors' desire to hold onto stocks for investment reasons.

37. Such a tension does not exist with derivative-based ETFs because investors can achieve their portfolio objectives without holding physical inventories. As a result, the potential for price disruptions is smaller with derivatives-based ETFs. Moreover, by reducing the "float" of physical inventories, physical-based ETFs can make markets more vulnerable to squeezes and corners (a phenomenon that has occurred in Treasury securities markets, as an example). It would be perverse indeed if a regulation—position limits—intended to reduce unwarranted fluctuations of the prices of commodities that consumers buy and producers sell has the exact opposite effect. Due to the very real possibility—indeed, one that is already occurring—that limits will shift some trading from derivatives markets to physical markets, the Commission's proposal substantially raises the risk of such unwarranted fluctuations.[5]

The Spot-Month Limits on Delivery-Settled and Cash-Settled Contracts Are Logically Inconsistent

38. The foregoing comments focus on the non-spot limits, but there are problematic aspects to the spot month limits as well.

39. Conceptually, there is a justification for spot month limits as a means to reduce the likelihood and severity of corners and squeezes.[6] However, the limit proposal contains certain logical inconsistencies that undermine its utility and efficiency as a means of preventing manipulation.

Hunts and large silver merchandisers to engage in EFP transactions that transferred ownership of physical silver to the Hunts and simultaneously reduced their futures positions.

[5] London Metal Exchange statistics indicate that at the end of 2010, a single firm owned approximately 90 percent of copper warehouse stocks. Press reports state that this party took ownership of physical copper in order to create a physical-based ETF. At the time that this firm took ownership, price relations in the market (notably the cash-three month spread) were symptomatic of a squeeze or congestion.

[6] In my opinion, there are superior ways to achieve this outcome, namely the use of enforcement authority or third party litigation to impose sanctions on those who have engaged in manipulative conduct. However, given the spotty record of enforcement actions against market power manipulation, a case can be made that spot month limits are desirable.

40. The proposal assigns different limits to delivery-settled and cash-settled contracts. For delivery settled contracts, the limit is one-quarter of the estimated deliverable supply. As written, the proposal does not impose any limit on the ownership of deliverable supply. For cash-settled contracts, the limit is five times the spot month position limit, i.e., 25 percent more than deliverable supply. Moreover, the limit permits the holder of the cash-settled futures to own up to one-quarter of the deliverable supply. Thus, the combined deliverable supply-cash settled position can reach 150 percent of deliverable supply.

41. The delivery-settled limit implicitly assumes that ownership of less than one-fourth of the deliverable supply is sufficient to distort prices.[7] If this is true, the holder of cash-settled futures could buy up one-fourth of deliverable supply, hold it off the market to inflate prices, and profit on his cash-settled derivatives as a result of the price inflation. But this would allow the owner of the cash-settled position to earn more than five times the profit as the holder of a delivery-settled contract because the position limit on the former is five times the limit on the latter.

42. This means that either the delivery-month limit is too small, or the cash-settled limit is too large, if the intent of the limits is to impose identical restrictions on the exercise of market power across contract types. These limits are certainly inconsistent with one another based on an understanding of the economics of manipulation.

43. Moreover, unless the spot month limit for delivery settled contracts incorporates ownership of the deliverable supply when calculating adherence to the limit[8], it would permit someone to hold any amount of the deliverable supply. If taking ownership of a sufficient quantity of the deliverable supply permits an individual or firm to distort prices, the holder of a futures position equal to one-fourth of the deliverable supply could still profitably manipulate by buying enough of that supply in the cash market to distort prices and liquidating the futures position at the artificially inflated price.

44. In brief, although the purpose of the spot month limits is clear and reasonable, the details of these limits are not well-designed to achieve this purpose.

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[7] "Less than one-fourth" because to profit, a manipulator takes deliveries (or buys up the deliverable commodity) to drive up prices, but must sell some futures at the inflated price. If taking ownership of at least one-fourth of deliverable supply is necessary to distort prices, the holder of a futures position equal to one-fourth of deliverable supply could not manipulate profitably (unless he owned deliverable supplies not acquired via delivery). If, in fact, taking delivery of more than 25 percent of deliverable supply is necessary to distort prices, the limit is too small.

[8] This is not stated explicitly in section 151.4(a)(1) of the proposal that pertains to delivery settled contracts, whereas the cash-settled contract limit section 151.4(a)(2)(ii) does explicitly reference ownership of deliverable supply.

Summary and Conclusions

45. In sum, the Commission is to be complimented for identifying exactly how large speculative positions can distort markets. Unfortunately, it has proposed limits on speculative activities that are far more expansive and restrictive than is necessary to prevent or diminish the distortions arising from the conditions that the Commission identifies. The limits are over-inclusive, and will throw the baby out with the bath. There are less intrusive and expansive policies that would address the real concerns that the Commission has raised, but which would not interfere with beneficial, legitimate trading activities that pose no such concerns—which the rule as written would do.

46. One final comment is warranted. Position limits are often advocated as a means of preventing large increases in the prices of energy, agricultural commodities, and metals like observed in 2006-2008, and which is recurring today. I would note that the Commission does not claim that its limits would have this effect. Nor does it claim that speculation has been the cause of these large changes in commodity prices. It is wise that it does not make such a claim, because there is no valid empirical support for it. Indeed, the empirical evidence contradicts assertions that speculation has caused prices to become artificially high.

47. Given that, it is important that the case for position limits be based on the specific risks identified by the CFTC. As I have argued above, based on these specific risks, the position limit proposal is flawed: it is a blunderbuss approach that will kill much perfectly legitimate trading that does not create these risks. But to utilize unsupported connections between speculation and recent price spikes to justify the adoption of limits would only compound the error by resulting in the adoption of the limits under false pretenses.

48. If the Commission believes that there is a connection between speculation and the kinds of price increases that have occurred in recent years, it should make the case in its proposal and provide the supporting evidence. If it does not believe this, or cannot provide evidence to support this belief, the experience in 2006-2008, or current movements in commodity prices, should play no part in deliberations over the rule. The rule should rise or fall on the basis of the specific problems that it is intended to address, and the reasonableness of the proposed remedy to these problems. As it stands, the proposed rule is an unreasonable and inefficient way to address the risks that the Commission has identified. Therefore, the Commission should reject the proposed rule.