COMMENT

Commodity Swap Position Limit Rule May Help Return Price-Risk Management

Michael Greenberger, University of Maryland Law professor and former adviser to the UN and director of the Commodity Futures Trading Commission's division of trading and markets, says position limit rules may protect investors who hedge risk using swaps.

It has been accepted in important quarters, especially in Congress in passing Dodd-Frank, that excessive speculation in commodity derivatives has unnecessarily caused volatile pricing in these markets in defiance of market fundamentals.

Although since 1936, federal law banned excessive speculation, beginning in 1991 that ban was weakened by non-public exemptions to speculators by Commodities Future Trade Commission staff. For example, sponsors of approximately $500 billion in commodity index swaps sold to passive investors have been exempt from position limits. Markets that had historically been 70 percent commercial are now often 80 percent speculative.

A 2008 Texas A&M study found that excessive speculation was so destabilizing that futures markets were no longer fit for "price-risk management." A similar study by Masters and White reported that between 2003 and 2008 excessive speculation increased the prices of 25 commodities by an average of 200 percent. Earlier this month, 461 economists from over 40 countries endorsed the position that excessive speculation is "increasing volatility and record food prices, exacerbating global hunger and poverty."

In response to these complaints, the drafters of Section 737 of Dodd-Frank intended to reverse the wave of position limit exemptions in the pre-Dodd-Frank era. The statute had to be implemented by a final CFTC rule. Last week, the CFTC adopted by a 3-2 vote the long-awaited position limits rule, mandated by Dodd-Frank to curb excessive speculation in commodity markets.

Early examination of the final rule is hampered because the regulation and its justification only became public at press time. Based on the public CFTC hearing and related media accounts, some analysis is now possible.

The final rule creates two types of limits in each of 28 derivative markets.

- The spot-month limit applies to physical-delivery derivatives in the period immediately before delivery obligations occur and to cash-settled contracts in the period immediately before contract liquidation. The limit for speculation is 25 percent of a commodity's estimated physical deliverable supply to be adjusted biennially for agricultural contracts and annually for energy and metals.

- The non-spot month limit is 10 percent of open interest in the first 25,000 contracts and 2.5 percent of open interest in all remaining contracts. The limit—to be adjusted biennially—applies to positions a speculator has in all contract months combined or in a single contract month to be calculated on a net basis. Since volume in non-spot month contracts makes up the vast majority of volume across the relevant markets, the non-spot limits will likely be a significant restraint.

The final rule largely replicates the CFTC's proposed January 2011 rule, preserving exemptions from limitations for bona fide hedgers and reversing loopholes in that definition that existed before Dodd-Frank. Like the proposal, the final rule restricts speculation by applying limits to *swaps* that are economically equivalent to futures. Before Dodd-Frank, swaps were not subject to limits.

While the final rule, unlike the proposal, allows speculators to exempt independently controlled customer accounts from limits, it still requires them to aggregate positions that they own or control, thereby preventing speculators from avoiding limits by allocating trades to subsidiaries or affiliates.

The final non-spot-month limit creates a higher speculative limit than does the proposal. The proposed and final non-spot-month limits are based on the same percentage of open interest; however, the final rule applies the percentage to the amount of open interest in futures and swaps combined, while the proposal only applied the percentage to open interest in futures *or* swaps depending on the transaction being regulated.

Also, Henry Hub Natural Gas contracts are exempt from the rule's standard position limits.

However, exclusive of natural gas, the final rule generally applies the spot-month limit on a one-to-one basis for physical-delivery and cash-settled contracts, so that a speculator may only control 25 percent—not 125 percent—of deliverable supply.

The final rule will likely be challenged in court. The large speculators have complained that position limits are overly restrictive; arguments tracked by the two dissenting commissioners. Advocates of robust regulation argue that the limits are too high.

The immediate question is whether a reviewing court will stay the rule's implementation pending final judgment. Such a stay would delay implementation by at least another year or two. Moreover, a stay, while only temporary, often reflects the court's sentiments on final judgment.

Conversely, denial of a stay may indicate that the rule will ultimately be sustained. A stay would likely come in late winter/early spring.