India: Weak Position Limits Cannot Tackle Speculation in Commodities

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After months of delay, the US commodity regulator – Commodity Futures Trading Commission (CFTC) – finally approved new rules to limit traders' positions on 28 physical commodity futures (and swaps) contracts.

On 18 October 2011, the CFTC's decision was arrived through a 3-2 vote along party lines, with the commission's three Democrats forming the majority against the two Republicans. The new restrictions (called position limits) on the number of contracts traders can hold are an important component of the Dodd-Frank Wall Street Reform and Consumer Protection Act (2010) to regulate commodities trading. But their detailed workout plan and actual implementation by CFTC got delayed largely due to strong opposition from the Wall Street.

The position limits would be imposed on 19 agricultural contracts (such as CBOT Corn and ICE Futures U.S. Cocoa), 4 energy contracts (such as Hub Natural Gas and NYMEX NYH Gasoline Blendstock), and 5 metals contracts (such as COMEX Copper and NYMEX Platinum).

As per the information made available by the CFTC, the new position limits would be implemented over a period of time in two phases. The position limits on 9 agricultural commodity contracts (including CBOT Corn and CBOT Wheat) will come into effect 60 days after CFTC passes a separate rule which would legally define the term "swap." For the rest of contracts, the limits will come into force once the one year of interest data is collected and analyzed by the CFTC. One wonders why CFTC has announced such a vague, open-ended time framework despite the fact that the US Congress has given the agency an explicit directive to impose position limits.

The position limits have been divided into two types: spot-month and non-spot-month. The spot-month position limits will be 25 percent of deliverable supply of commodities. However, this limit would be applied separately for physically-delivered contracts and cash-settled contracts. For non-spot month, the position limits will be set at 10 percent of the open interest for the first 25000 contracts and 2.5 percent thereafter. Agricultural contracts will be adjusted twice a year whereas energy and metals contracts will be adjusted on an annual basis.

Surprisingly, special exemptions have been provided under the new rules for "hedging" operations thereby allowing the so-called "bona fide hedgers" to exceed the position limits. The CFTC has also given exemptions for positions that are established in "good faith" prior to the effective date of the initial limits. It is not clarified that who should be qualified for these exemptions. Besides, the CFTC has exempted NYMEX HH Natural Gas contracts (the delivery point for the natural gas futures contract traded on the New York Mercantile Exchange) from these limits. Cash-settled position and aggregate limits will be set at five-times the limits for the physical-delivery HH Natural Gas contracts.

The stated policy objective behind the imposition of position limits is to curb excessive speculation and market concentration in the US commodity markets. According to Gary Gensler, chairman of CFTC, the new limits have been introduced to ensure that "markets do not become too concentrated."

Will new rules be effective in curbing reckless speculation and market concentration? It is too early to predict the potential impact (positive and negative) of these curbs on the US commodity markets. But a narrow scope coupled with exemptions and open-ended time framework may not yield positive results.

In the present times, no single policy tool alone could fix excessive speculation in the US commodity markets. If implemented correctly along with other regulatory measures and continuously monitored, the position limits could serve as a first step towards orderly functioning of commodity derivatives markets.

To a large extent, the effectiveness of position limits would also be dependent on the quality of market surveillance program of the CFTC. The proposed budget cuts to the CFTC could seriously undermine its ability to effectively supervise these rules.

In the coming days, the implementation of position limits would be strongly resisted by Wall Street and conservative think-tanks. The opponents of position limits could challenge these rules on superfluous technical or legal grounds. As pointed out by Felix Shipkevich, an expert on CFTC rules, "the opponents may use another strategy that has worked against Dodd-Frank. The Chamber of Commerce was able to strike down one Dodd-Frank rule written by the SEC by arguing that the agency inadequately assessed the rule's cost-benefit ratio."

Since the US presidential and congressional elections are to be held next year, this issue would remain a major bone of contention between Democrats and Republicans.

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