



Position Limits and Potential Impacts on Hedgers

Paul Peterson

Department of Agricultural and Consumer Economics
University of Illinois

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Last week the Commodity Futures Trading Commission (CFTC) announced the reopening of the public comment period for its [latest proposal](#) on position limits for agricultural commodities. This marks the eighth time since 2010 that the public has had an opportunity to comment on some aspect of position limits, and the fourth time for much of this particular proposal, so it is worthwhile to review the purpose of position limits, explain why this issue is important to *farmdoc daily* readers, and explore some of the reasons why this decision has been so difficult.

Background

Commodity position limits – the maximum number of futures contracts that can be owned or controlled by an individual or entity – are the primary tool used by regulators to control futures market speculation. Limits were authorized in 1936 by the Commodity Exchange Act as a way to prevent “excessive speculation” which according to the Act can result in “...sudden or unreasonable fluctuations or unwarranted changes in the price...” The role of position limits was strengthened by the Dodd-Frank Act and applied to 28 “core” physical commodities: 19 agricultural commodities, five precious and industrial metals, and four energy contracts.

Although position limits are intended to control the activities of speculators, these limits also apply to hedgers, although bona fide hedgers and certain other non-speculative market participants may apply for exemptions. When an exemption is granted, the hedger is assigned a customized position limit for limited period of time. Readers are referred a three-part *farmdoc daily* series ([October 17, 2012](#), [October 24, 2012](#), [October 31, 2012](#)) for a detailed discussion.

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Why Does This Matter?

Even in bumper-crop years like 2014, most *farmdoc daily* readers will never have futures positions large enough to bump up against these CFTC limits. But companies in the next step of the marketing chain – grain elevators, meatpackers, and dairy processors on the end-product side; refineries, distributors, and various other suppliers on the input side – commonly deal with position limits because of the larger volumes of commodities they handle and the correspondingly larger numbers of futures contracts required to hedge those positions. If these firms are prevented from effectively managing price risks, those risks may be passed along to farmers in the form of lower prices for the products they sell and higher prices for the supplies they buy.

Hedger Concerns

Of all the futures-related areas affected by Dodd-Frank, position limits has been the most contentious, including one set of new rules that was struck down by a federal district court and sent back to the CFTC for further work. One might expect that most of the complaints have come from individuals and groups opposed to speculation, but in fact the strongest objections have come from commercial hedgers. Readers can view the comment letters [here](#).

One of the important issues is the CFTC's tighter definition of "bona fide hedging." At the present time, most uses of futures by commercials in connection with the management of price risks are considered to be hedging. But the CFTC's proposal would restrict the use of anticipatory hedges – those in which the need is known but there is not yet a formal commitment to buy or sell the cash commodity. It also would limit the hedging horizon to a maximum of 12 months, and require a minimum 0.8 correlation between the futures contract and the commodity being hedged.

Another issue is the proposed requirement that all futures positions of separate divisions within the same company to be combined, or "aggregated," into a single company-wide total. To illustrate, suppose that at a large grain company one division buys corn from farmers, another division buys corn from country elevators to load barges on the river, and a third division buys barges of corn at the Gulf to load export ships. The three divisions operate independently, but under the proposal they would be required to combine their futures positions into a single number.

Yet another issue is the position limits themselves. Storable commodities including most crops have different seasonal production patterns and price characteristics than continuously-produced (and often nonstorable) commodities such as livestock or dairy. Over time, position limits have evolved on a commodity-by-commodity basis, incorporating features that reflect the characteristics of the underlying cash markets.

In an effort to create consistency, the CFTC proposal would apply a uniform rule across all 28 commodity markets. However, the impact on agricultural markets would be anything but uniform, resulting in substantial position limit increases across the board for certain commodities – notably grains – but substantial decreases for other commodities – primarily livestock and dairy. Most of these decreases are caused by re-imposing an all-months-combined limit that was shown to be unnecessary for nonstorable commodities and was eliminated in the early 1990s. A detailed table of position limit levels for selected agricultural commodities can be found [here](#).

A fourth issue is the potential impact of these new rules on market liquidity. Agricultural markets account for less than 6% of global trading volume, so it is important to maintain speculative activity and the liquidity it provides. One of the recurring themes in the commercial comments was the need for adequate market liquidity so that hedgers can enter and exit these markets without distorting prices.

CFTC Actions and Next Steps

To be fair, the CFTC is not entirely to blame for these developments. Much of the problem stems from the language in Commodity Exchange Act, which points to “excessive speculation” without ever defining what “excessive” might be. Further aggravating matters, the 2,319-page Dodd-Frank Act imposed strict requirements on major changes that the CFTC and other regulators must make, but provided little guidance on how those changes should be accomplished. This has produced a time-consuming and largely trial-and-error approach to devising rules that meet the requirements of the law without adversely affecting legitimate market participants.

There is a fine line between preventing market disruptions and driving away liquidity. Developing viable futures markets is a difficult task, and great care must be taken by all sides to strike a reasonable balance between market safety and market effectiveness.

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