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Position Limits, Excessive Speculation and the Dodd-Frank Act

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Commodity position limits – the maximum number of futures contacts that can be owned or controlled by an individual or entity – have been in the news since Judge Robert L. Wilkins of the US District Court for the District of Columbia rejected a new system of position limits developed by the Commodity Futures Trading Commission (CFTC). To help our readers understand the implications of this action, today's farmdoc Daily will lay the groundwork by reviewing the history and operation of position limits. A later post will discuss the rejected CFTC position limits and evaluate the impact of Judge Wilkins' ruling.

The Commodity Exchange Act was enacted in 1936, and authorized the use of position limits to prevent excessive speculation. Quoting from Section 4a, "Excessive speculation in any commodity… causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity, is an undue and unnecessary burden on interstate commerce. For the purpose of diminishing, eliminating or preventing such burden" the Commodity Exchange Act prescribes "limits on the amounts of trading which may be done or positions which may be held by any person." Although it has been amended several times since it was enacted, these basic principles regarding speculation and the role of position limits have remained intact.

Other tools that have been used to control speculation include daily price limits that control the amount that prices can change – up or down – from the previous day's settlement price, and daily trading limits that control the number of contracts that any individual can trade in a day. Price limits have been relaxed over the years as views about the tradeoffs between price volatility and price discovery have evolved, and trading limits were eliminated in the 1970s because they restricted market liquidity during active trading periods, which is when liquidity is needed the most. This leaves position limits as one of the primary regulatory tools for controlling speculation.

There are several types of position limits. Spot limits apply to contract months in or near the delivery or final settlement period, when the risk and potential impact of a market disruption are greatest. Non-spot or single-month limits apply to all other contract months of the same commodity. There also may be aggregate or all-months-combined limits that cap the total number of futures contracts of a particular commodity that may be held, and cover both spot and non-spot contract months. Aggregate or all-months-combined limits may apply to all contract months of the same commodity, or to only months within a particular crop year or other production cycle. Position limits are expressed in terms of "futures contract equivalents" but apply equally to option positions. Options are converted to futures contract equivalents using the option delta – the ratio of the option price change to the underlying futures price change – and then options and futures positions for the same commodity and contract months are combined into a single total.

Position limits are often referred to as "speculative position limits," but contrary to popular belief these limits apply equally to hedgers. Bona fide hedgers and certain other non-speculative market participants may apply for exemptions, which are evaluated on a case-by-case basis. If granted, a position limit exemption does not allow the holder to have an unlimited number of contracts. Instead, it provides a customized position limit and position liquidation schedule, and is granted for a limited period of time.

Position limits have evolved over the years on a commodity-by-commodity basis, incorporating features that reflect the characteristics of the specific futures and options contracts and the underlying cash markets. For example, grains, oilseeds and cotton are the oldest futures markets, and were covered by so-called "federal limits" that originally were set and administered by the Commodity Exchange Authority, the predecessor of the CFTC. Current position limits in these markets retain many features of the federal limits. These commodities have distinct seasonal production patterns and are storable, so supplies and prices within the same crop year are linked by carrying costs. Deliverable supply is an important factor because it determines whether or not a market is vulnerable to a "squeeze" or other market disruption. As a result, these markets have a combination of spot month and non-spot month limits, plus all-months-combined limits to prevent market distortions in one month from affecting prices in other related months.

At the other end of the spectrum are livestock and dairy. These futures markets are much newer, the commodities are produced continuously and for the most part they are non-storable. These markets were never covered by the federal limits, and instead use position limits established by the respective exchanges with prior approval by the CFTC. The supplies and prices in any month are largely independent of supplies and prices in other months, so these markets do not have all-months-combined limits, and instead use only spot month and non-spot month limits.

Still other commodities, including many financial markets where the supply of the underlying instrument is virtually unlimited, rely on a method known as position accountability. Position accountability does not impose an absolute limit on the number of contracts that can be owned or controlled. Instead, it requires the holder of positions above a certain level to justify the need for such a large position by providing details about the nature of the position, trading strategy, and other information upon request. In addition, some markets for physical commodities for which production is continuous and the supply is extremely large – including precious metals and energy – use a hybrid system of position accountability for non-spot months and position limits for spot months.

The CFTC has required position limits on all commodity futures contracts since 1981. However, there are no position limits for swaps, which have been exempted from most provisions of the Commodity Exchange Act since 2000. Swaps are customized futures- or option-like instruments traded over-the-counter by eligible participants. These instruments can be tailored to a particular hedger's needs and have experienced dramatic growth since they were introduced in 1981. However, some swaps have been designed as clones or near-clones of standardized futures and options contracts, so they are able to function much like the regular exchange-traded products except they have no position limits.

Swaps on financial instruments – not agricultural or other physical commodities – played a central role in the 2007-2008 financial crisis, so the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) made substantial revisions to the Commodity Exchange Act to bring all swaps under the CFTC's regulatory purview. The CFTC is responsible for developing regulations to implement the Dodd-Frank legislation on areas involving futures, options and swaps, and a dispute over the CFTC's interpretation of Dodd-Frank's mandates led to Judge Wilkins' ruling.

The rejected CFTC position limits and the impact of Judge Wilkins' ruling on the commodity markets will be covered in an upcoming farmdoc daily post.