An Update on the Debate over Commodity Futures Position Limits

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Abstract

On 28 September 2012 a federal judge struck down the U.S. Commodity Futures Trading Commission's (CFTC's) current iteration of federal position limits on holdings of commodity futures contracts. A month and a half later, the CFTC announced that the commission would appeal the court's decision. At this time, therefore, the federally imposed position limits are in limbo.

EDHEC is one of the top five business schools in France. Its reputation is built on the high quality of its faculty and the privileged relationship with professionals that the school has cultivated since its establishment in 1906. EDHEC Business School has decided to draw on its extensive knowledge of the professional environment and has therefore focused its research on themes that satisfy the needs of professionals.

EDHEC pursues an active research policy in the field of finance. EDHEC-Risk Institute carries out numerous research programmes in the areas of asset allocation and risk management in both the traditional and alternative investment universes.

Federal Court Decision

The federal court's 50-page decision, which vacated the CFTC's position-limit rule, was not political. When one has the rule-of-law, decisions are based on logic, and this ruling is very logical.

What was the court's logic?

Essentially in prior federal agency decisions to impose speculative position limits, dating back to 1938, the relevant agency had made "necessity findings in its rulemakings" of actual or potential harmful excessive speculation.

The CFTC precisely did not so during the current iteration of federal position limit rulemakings. And in fact, three CFTC Commissioners noted that no such finding had been made when the commission approved position limits in October of 2011. The court essentially found that a plausible, "plain reading" of the Dodd-Frank amendments to the Commodity Exchange Act could lead one to conclude that the CFTC still needed to make a finding of necessity before imposing new limits.

The court acknowledged that there is some ambiguity on this point; that is, there is more than one plausible interpretation of the Dodd-Frank amendments regarding whether the imposition of federal position limits is mandatory or not. That said, the court ruled that the CFTC would need to specifically address this ambiguity with its expertise rather than asserting that this ambiguity does not exist.

The court decision is therefore nuanced. If the CFTC does at some point make a finding of the economic necessity of its federal position limit rules, rather than assert that Congress made it mandatory for these limits to be imposed, regardless of need, then one could expect that a later imposition of position limits could survive a future court challenge.

A Finding of Economic Necessity

It may be challenging for the CFTC to make a finding of economic necessity, which would thereby require position limits to be imposed on all commodity futures markets.

For example, a CFTC economist memorandum from 21 August 2009 stated that:
"In our analysis of the impact of position limits, we find little evidence to suggest that changes from a position limit regime to an accountability level regime or changes in the levels of position limits impact price volatility in either energy or agricultural markets. Our results are consistent with those found in the existing literature on position limits."

That said, one fact to emphasise is that some U.S. agricultural futures markets currently do operate under a position-limit regime defined by the CFTC, so one has to be careful in arguing that position limits are a particularly onerous constraint on market participants, at least under current rules. The disadvantage in focusing on position limits was noted by former CFTC Commissioner Michael Dunn on the energy markets:

"My fear is that, at best, position limits are a cure for a disease that does not exist. Or at worst, a placebo for one that does."

Economic Role of Futures Markets and Commodity Speculators

It may be a good idea to review the economic role of futures markets and speculators, given the evident confusion on the usefulness of this institution and its professional participants.

One should start by noting that the terms, "hedging" and "speculation," are not precise. A commodity merchant who hedges inventories creates a "basis" position and is then subject to the volatility of the relationship between the spot price and the futures price of the commodity. The merchant is, in effect, speculating on the "basis". The basis relationship tends to be more stable and predictable than the outright price of the commodity, which means that the merchant can confidently hold more commodity inventories than otherwise would be the case. What futures markets make possible is the specialisation of risk-taking rather than the elimination of risk.

Who would take the other side of the commercial hedger's position? Answer: A speculator who specialises in that risk bearing. The speculator may be an expert in the term structure of a futures curve and would spread the position taken on from the commercial hedger against a futures contract in another maturity of the futures curve. Or the speculator may spread the position against a related commodity.

Alternatively, the speculator may detect trends resulting from the impact of a commercial's hedging activity, and be able to manage taking on an outright position from a commercial because the speculator has created a large portfolio of unrelated trades. Presumably, the speculator will be able to dampen the risk of an outright commodity position because of the diversification provided by other unrelated trades in the speculator's portfolio. In this example, the speculator's risk-bearing specialisation comes from the astute application of portfolio theory.

What then is the economic role of commodity speculation and its "value to society"? Ultimately, successful commodity speculation results from becoming an expert in risk bearing. This profession enables commercial entities to privately finance and hold more commodity inventories than otherwise would be the case because they can lay off the dangerously volatile commodity price risk to price-risk specialists. Those commercial entities can then focus on their area of specialty: the physical creation, handling, transformation, and transportation of the physical commodity.

In the absence of being able to hedge inventories, a commercial participant would not rationally hold "large inventories ... unless the expected price increase is greater than that which would be required to cover cash storage costs by an amount large enough to offset the additional risk involved," noted the financial economist Paul Cootner.

If the existence of price-risk-bearing specialists ultimately enables more inventories to be created and held than otherwise would be the case, we would expect their existence to lead to the lessening of price volatility. To be clear, why would this be the case?

The more speculators there are, the more opportunity there is for commercial hedgers to find a natural other side for hedging prohibitively expensive inventories. This in turn means that more inventories can be economically held. Then with more inventories, if there is unexpected demand, one can draw from inventories to meet demand, rather than have prices spike higher to ration demand.

Reduction of Volatility

There is some empirical evidence to support the theory that speculative involvement *actually* reduces price volatility.

For example, Professor David Jacks of Simon Fraser University examined what happened to commodity-price volatility, across countries and commodities, before and after specific commodity-contract trading has been prohibited in the past. Professor Jackson also examined commodity-price volatility before and after the establishment of futures markets, across time and across countries. Jacks' study included data from 1854 through 1990. He generally, but not always, found that commodity-price volatility was greater when there were *not* futures markets than when they existed, over 1-year, 3-year, and 5-year time frames.

More recently, Professor Scott Irwin of the University of Illinois at Urbana-Champaign and Professor Dwight Sanders of Southern Illinois University noted in 2011 that "[commodity] index positions [have] led to lower volatility in a statistical sense", when examining 12 agriculture markets and 2 energy futures markets from June 2006 to December 2009. Specifically, "there is mild evidence of a negative relationship between index fund positions and the volatility of commodity futures prices, consistent with the traditional view that speculators reduce risk in the futures markets and therefore lower the cost of hedging".

Empirical Evidence on the Role of Both Speculators and Financial Investors

In May 2010, the *Wall Street Journal* obtained unreleased CFTC reports through a Freedom of Information Act request. According to these reports, CFTC staff had found that for crude oil prices from January 2003 to October 2008, price changes *led* position changes, rather than the other way around. If speculators were indeed driving price changes over this period, one would have expected their position changes, instead, to have *led* price changes. This particular time period was noteworthy since it encompassed the July 2008 crude oil price spike.

Evidence on the Impact of Commodity Index Funds

Did commodity index investments in 2008 cause the 7-month oil-price rally that culminated in July of 2008? According to data released by the CFTC on 11 September 2008, this is an unlikely cause, given that total Over-the-Counter (OTC) and on-exchange commodity index investment activity in oil-futures-contract-equivalents actually *declined* from 31 December 2007 through 30 June 2008. Please see Figure 1.

Figure1: Excerpt from staff report on commodity swap dealers & index traders with commission recommendations

Total OTC and On-Exchange Commodity Index Investment Activity

	12/31/07	3/31/08	6/30/08
Crude Oil Index Values Measured in Futures [Contract] Equivalents	**408,000**	**398,000**	**363,000**

Partly because of results such as in Figure 1, a futures exchange spokesman stated in early 2010 that the U.S. regulatory attention on oil markets had shifted to a focus on "market concentration and not about speculation" because the evidence on excessive speculation did not bear out.

Historical Lessons

Public scrutiny of, and ssepticism about, commodity futures markets has had a long tradition in both the United States and in Continental Europe, dating back to (at least) the last great era of globalisation in the late nineteenth century. Over the past 120 years, two determinations have historically prevented futures trading from generally being banned or heavily restricted.

The first supportive determination has been a general (although not unanimous) recognition by policymakers that futures markets serve a legitimate economic purpose. The second determination has been to base public policy on an objective examination of extensively gathered facts, which are summarised via appropriate statistical measures. One would hope that U.S. public policy governing commodity futures markets will continue to be based on this framework. The very logical federal court decision of September 2012 does give one a measure of confidence that this framework could continue to be the case.

Founded in 1906, EDHEC Business School offers management education at undergraduate, graduate, post-graduate and executive levels. Holding the AACSB, AMBA and EQUIS accreditations and regularly ranked among Europe's leading institutions, EDHEC Business School delivers degree courses to over 6,000 students from the world over and trains 5,500 professionals yearly through executive courses and research events. The School's 'Research for Business' policy focuses on issues that correspond to genuine industry and community expectations.

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In 2012, EDHEC-Risk Institute signed two strategic partnership agreements with the Operations Research and Financial Engineering department of Princeton University to set up a joint research programme in the area of risk and investment management, and with Yale School of Management to set up joint certified executive training courses in North America and Europe in the area of investment management.

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