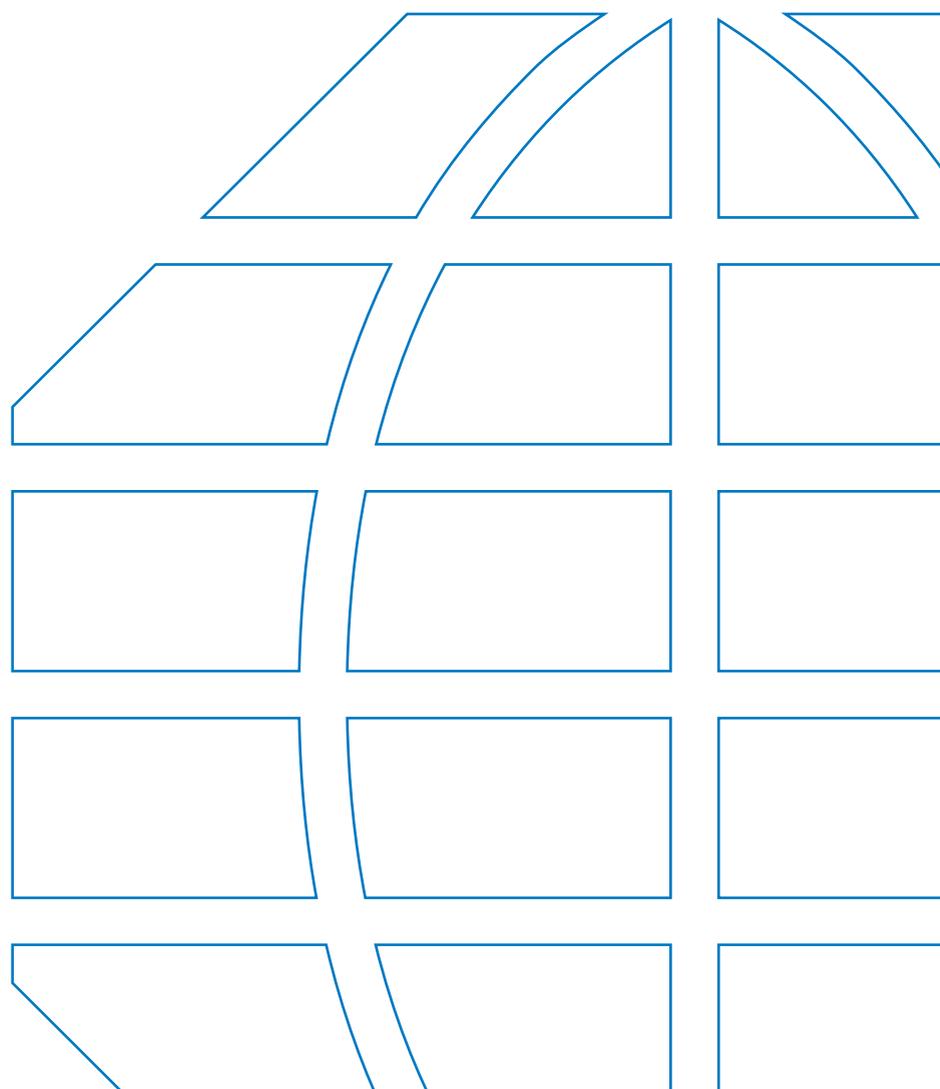


Excessive Speculation and Position Limits in Energy Derivatives Markets



EXECUTIVE SUMMARY

During the period from 2002 to 2006, energy prices, like other commodity prices, trended consistently higher and then increased dramatically from 2007 to mid-2008, in many cases to historical highs. Although the prices of most commodity products have since decreased significantly from those highs, the prices experienced in 2008 triggered a number of investigations and analyses of the causative factors underlying these price changes. For example, numerous hearings on the issue have been held in both the Senate and the House of Representatives, and a review was conducted by the U.S. Government Accountability Office at the request of the House Agricultural Committee. Reports have been issued by academics and research groups addressing the topic. Nearly all economists that have carefully studied these markets have concluded that supply and demand fundamentals and other macroeconomic factors were the cause of these price movements.¹

However, a small but vocal group has argued that “excessive speculation” was, and remains, the cause of prices deemed to be “too high” and they often point to the risk management activities of swap dealers and index funds as the primary “speculative” force driving high prices. These claims are unsupported by any empirical evidence or legitimate economic analysis, including the Commodity Futures Trading Commission’s (CFTC) own data and analysis.² To the contrary, the activity of speculators, as well as swap dealers and index funds, are essential to creating the liquidity necessary for the efficient functioning of the market and make it possible for traditional commercial participants to manage their risk.

CME Group strongly opposes regulatory policies that unfairly discriminate against index funds and swap dealers in their ability to access energy and commodity futures markets. There is already significant evidence that CFTC actions to repeal no-action letters that granted exemptions from position limits to two index funds and the rhetoric regarding the possible imposition of position limits on swap dealers and index funds without allowance for exemptions

is pushing these participants to exempt-over-the-counter (OTC) swap markets, foreign exchanges with less restrictive or non-existent position limits requirements, and even domestic securities markets. Market participants are also developing other product substitutes that will allow investors to bypass the regulated exchange markets in the United States.

CME Group supports the CFTC’s mission to ensure that energy markets effectively serve their important economic functions for the benefit of all market participants. Although the evidence is clear that speculative position limits in the energy markets, beyond those already in place, are not warranted, we also recognize that confidence in the futures markets may be undermined by perceptions. Therefore, CME Group is proposing the following recommendations:

- Each regulated exchange should set position limits for all months combined, single months and the delivery period based on traditional considerations, focusing on its open interest and, at or near the delivery period, the deliverable supply.
- Each exchange shall be responsible for administering its hedge exemption program for its markets subject to its existing exemption standards until such time as common exemption standards are established by the CFTC. Swap dealers and index funds will remain eligible for risk management exemptions to hedge bona fide exposure but be subject to position limits for their speculative proprietary trading.
- The CFTC will establish a system for reporting of end-user OTC positions and, after gaining authority to impose aggregate limits that include OTC positions, be responsible for ensuring an end-user’s combined on-exchange and OTC speculative positions do not exceed the aggregate total market position limit.

We are prepared to lead, but any steps taken to impose hard position limits must support the national policy of enhancing transparent markets and central counterparty clearing and prevent market participants from moving away from the best regulated, most transparent, safest marketplace to less regulated or even completely

¹ See e.g. Philip C. Abbott, Christopher Hurt, Wallace E. Tyner, “What’s Driving Food Prices,” Farm Foundation, Issue Report (March 2009 Update); Ronald Trostle , “Global Agricultural Supply and Demand: Factors Contributing to the Recent Increase in Food Commodity Prices,” A Report from the Economic Research Service of the USDA (July 2008); and Ennis Knupp & Associates, “The Role of Institutional Investors in Rising Commodity Prices” (June 2008).

See also, U.S. Government Accountability Office, Issues Involving the Use of the Futures Markets to Invest in Commodity Indexes, (Jan. 30, 2009), available at <http://www.gao.gov/new.items/d09285r.pdf> , which analyzed the available data respecting any causal relationship between speculation and commodity prices and concluded that the eight empirical studies reviewed “generally found limited statistical evidence of a causal relationship between speculation in the futures markets and changes in commodity prices – regardless of whether the studies focused on index traders, specifically, or speculators, generally.” Id at 5.

unregulated markets that are and will continue to be beyond the control of the Commission and Congress. Consequently, in conjunction with our adopting a hard limits regime, exempt commercial markets (ECMs) and foreign boards of trade (FBOT) must do so as well for all similar contracts.

Our proposed hard limits regime is intended to be administered in a way that fosters competition among trading venues in all markets based solely on liquidity, technology, price, clearing capability and quality and customer service, not regulatory arbitrage.³ We caution, however, that efforts to increase confidence in the futures markets by imposing hard limits on energy products must be balanced with ensuring that such limits do not have a detrimental effect on the price discovery and hedging functions of futures markets or drive trading to unregulated markets. We believe that our carefully designed hard limits regime accomplishes these goals and represents an immediate improvement for those seeking to impose hard limits, while avoiding any unintended harm to the U.S. markets and their users.

AN HISTORICAL PERSPECTIVE

In developing a method for imposing position limits on specific energy products, it is also important to consider the history of speculative trading and speculators in futures markets. In fact, the theory that speculators on futures markets cause unwarranted price volatility and excessively high or low prices is not new; Congress has been repeating that notion since at least 1850. Farmers and their legislative representatives regularly demand the elimination of speculators on futures exchanges. However, the Commodity Exchange Act (CEA), which came into existence in the midst of an anti-speculation frenzy, does not limit speculation, but only “excessive speculation.” This is an implicit recognition of an indisputable economic principle — futures markets cannot operate without the participation of speculators. CFTC Chairman, Gary Gensler, recognized this principle in his recent testimony at the Commission’s hearings on position limits in the energy markets and exemptions therefrom (the Hearings).

The Hearings focused on concerns with “excessive speculation,” which resurfaced when fuel and food prices spiked to levels that were shocking to consumers and painful to the economy. Although prices later subsided significantly, the pressure to control a reoccurrence of price spikes has led to a search for a simple causal agent that can easily be neutralized.

The favored cause was speculators. But, speculators sell when they think prices are too high and buy when they think prices are too low. They are not a unified voting block and are on both sides of every market. Speculative selling and buying send signals to producers and processors that help keep our economy on an even keel. High futures prices for corn induced farmers to bring new acreage to market. High forward energy prices encourage exploration and new technology to exploit existing untapped reserves.

Futures markets perform two essential functions — they create a venue for price discovery and they permit low cost hedging of risk. Futures markets depend on short and long term speculators to make markets and provide liquidity for hedgers. Futures markets cannot operate effectively without speculators and speculators will not use futures markets if artificial barriers or tolls impede their access. As one noted scholar explains:

“Large speculators are frequently the most efficient bearers of risk. In the old days, large individual traders played the role of risk bearers. Today, futures funds and hedge funds that allow investors to diversify can perform this function. Unfortunately, position limits prevent these traders from bearing as much risk as they would like. Due to these limits, less risk-tolerant traders must absorb additional risk. This leads to an incomplete transfer of risk. This is costly.

Moreover, speculators are frequently well informed about supply and demand fundamentals. Their trading forces prices towards the level implied by this information. Since producers, consumers, processors, and storers of commodities rely upon futures prices to guide their decisions, having more information embedded in these prices will lead to better decisions. By limiting the ability of informed individuals to trade, however, position limits reduce the flow of information to the futures market. This reduces the efficiency of resource allocation.”⁴

² See Commodity Futures Trading Commission, Commodity Swap Dealers & Index Traders with Commission Recommendations, (Sept. 11, 2008), available at <http://www.cftc.gov/stellent/groups/public/@newsroom/documents/file/cftcstaffreportonswapdealers09.pdf>

³ Should concerns that “excessive speculation” is driving commodity prices in the metals derivative markets or adversely impacting liquidity in such markets arise in the future, we are prepared to consider a similar hard limits regime for metals contracts as well.

Thus, position limits that are too broad indeed impede speculators' access to the futures markets, undermining "the ability of the futures markets to perform their essential functions."⁵

THE ROLE OF SWAP DEALERS AND INDEX FUNDS

The targets of the latest "excessive speculation" claims are index funds and swap dealers. Neither, however, is engaged in traditional speculative activity — namely, trying to beat the market. Rather, both are engaged in legitimate risk management activity and contribute positively to the overall functioning of the futures market. Moreover, as discussed in more detail later in this paper, there is no reliable economic evidence to support the contention that either market participant drives commodity prices, including energy prices.

Swap Dealers

Swap dealers use futures markets to facilitate the hedging of more complex and specific risks accepted in connection with swap transactions with commercial customers and others, including institutional investors who seek broad exposure to commodity prices as an inflation hedge through commodity index swaps. Increased restrictions on swap dealers' ability to obtain exemptions from position limits will likely cause two unintended yet foreseeable consequences. First, limiting the hedge exemption for swap dealers could make it more costly for commercial enterprises and institutional investors to execute strategies in the OTC market to meet their hedging needs. Second, swap dealers may well widen spreads in order to internalize risks or attempt to hedge their risk through increased use of OTC instruments rather than exchange-traded futures. Both strategies undercut current regulatory and legislative efforts to reduce systemic risk by driving OTC-generated risk into a central counterparty clearing context.

Finally, the assertion that swap dealers were regularly and widely being used as intermediaries by speculators and others who would not have been entitled to a hedge exemption as a device to circumvent exchange position limits has been contradicted by the information so far released by the Commission of data obtained from swap dealers by use of its special call authority.

Index Funds

Index funds aggregate the buying and selling decisions of many thousands of investors, most of whom are diversifying their investment portfolios and hedging inflation risks to their investment returns in order to maximize their retirement savings and their individual wealth. Moreover, index funds supply a pool of stable, passive, unleveraged capital to bear commodity price risk.⁶ Thus, "by allowing commodity producers to transfer their inherent commodity price risk exposure to long-term investors who are better-suited to bear it, the participation of the index investors in the commodity futures markets lowers the cost of capital to commodity producers, and by lowering costs helps to lower commodity prices over the long run."⁷

Moreover, index funds, like those swap dealers hedging commodity index swaps, cannot make or receive delivery and consequently they must sell their long positions in the nearby contract month and establish long positions in a more distant month prior to the termination of trading in the nearby contract. Therefore, index investors clearly do not create artificial demand for the physical commodity.

Denying index funds a risk based exemption from position limits will preclude thousands of small investors from a cost effective means of investing in commodities. More importantly, the absence of such an exemption will reduce market liquidity and thereby increase the costs of hedging for producers, which costs will ultimately be passed on to consumers. Thus, some of the most vocal proponents of eliminating these risk-based exemptions will, contrary to their stated expectations, see commodity prices increase as a result of the very action they are encouraging.

⁴Craig Pirrong, *Squeezes, Corpses, and the Anti-Manipulation Provisions of the Commodity Exchange Act*, available at <http://www.cato.org/pubs/regulation/regv17n4/reg17n4c.html>

⁵Id.

⁶Testimony of Steven H. Strongin, Managing Director, Goldman, Sachs & Co. Before the Permanent Subcommittee on Investigations Committee on Homeland Security and Governmental Affairs, U.S. Senate (July 21, 2009) at 4, available at www.hsgac.senate.gov. ("Strongin Testimony").

⁷Id.

The Evidence

The assertion that commodity prices are being driven by swap dealers and index funds, directly and indirectly trading OTC with swap dealers, rather than by the expected forces of supply and demand, does not have a factual basis. Most every competent economist who has looked at real data, rather than anecdotes, and who has applied legitimate economic analysis concludes that neither speculators, swap dealers nor index funds are distorting commodity prices.⁸ Contrary to the assertion that these industry participants speculators are uniformly on the buy side and are pushing prices up on that basis, the publicly available data has been relatively consistent over time in demonstrating that speculators in crude oil futures contracts have been relatively balanced as between buy and sell positions in the market. In fact, *The Wall Street Journal* surveyed a significant cross section of economists who agreed that: “The global surge in food and energy prices is being driven primarily by fundamental market conditions, rather than an investment bubble”⁹ The weight of the evidence and informed opinion confirms that the high prices are a consequence of supply and demand factors external to speculative trading and the hedging of swap dealers and index funds on futures exchanges.

Expert economists, however, are being ignored and important legislation and regulation is in danger of being shaped by spurious economics that is profoundly flawed in its methodology and logic. Well-regarded economists who have reviewed the work of the “experts,” who have been lobbying for restrictive positions limits and the exclusion of swap dealers and index funds from futures markets, have found, among other flaws, that the proponents of the restrictions demonstrated:

(1) unfamiliarity with industry fundamentals resulting in misinterpretation of petroleum statistics; (2) confusion of the consequence of demand for physical product and demand for derivatives; (3) use of overly simplistic models; (4) arbitrary and meaningless characterization and measurement of “excessive speculation”; (5) misstatement of volatility trends; and (6) conflation of speculation and market manipulation.

The debate regarding controlling excessive speculation in the energy markets by means of position limits should be informed by two facts: first, it is rare for a single speculator, index trader or swap dealer to have control of a large share of the open interest in any futures contract, and second, efforts to control price or volatility by position limits has been a failed strategy. As an experienced futures trader in energy products explains:

“The U.S. natural gas market is very robust. The NYMEX NG physically settled futures contract is very well designed with dozens of companies able to both make and take delivery of the product. . . . The NYMEX NG contract is managed through expiration without giving anyone the ability to manipulate the market for the physical product. A significant amount of gas can be made available and delivered at contract specifications with minimal cost, and many users can actually make use of that product. At expiry, among many players available, a willing and knowledgeable buyer and seller, both having other options, must agree to exchange Henry Hub natural gas at the settlement price. The NG contract simply cannot deviate from fair value at expiration. The fact that so little actually goes to delivery is a testament to the efficiency of this market.”

Proponents of hard limits on speculative trading and the elimination of risk management exemptions believe that such limits will bring commodity prices to some favored level — in the case of energy commodities - down; in the case of cattle - up. Not only is there a complete disconnect between the implied promise to drive prices down or up (whichever the most vocal constituency desires) and the ability of position limits to deliver on that promise, but improperly calibrated and administered position limits can easily distort markets and increase costs to hedgers, which in turn increases costs to consumers.

⁸ David S. Jacks, *Populists versus theorists: Futures markets and the volatility of prices*, (June 2006), available at <http://www.isda.org/speeches/pdf/Onion-futures-Annex.pdf>.

⁹ Phil Izzo, *Bubble Isn't Big Factor in Inflation*, WALL ST. J., May 9, 2008, at A2.

THE SCOPE OF THE CFTC'S AUTHORITY RESPECTING POSITION LIMITS

The CFTC has adequate authority to set hard limits on energy contracts trading on registered exchanges and, in limited circumstances, trading ECMs, which have been essentially exempt from CFTC oversight.

Section 4a(a) of the CEA directs the Commission to fix position limits for a commodity traded on a "designated contract market" (DCM), i.e., regulated futures exchange, or a "derivatives transaction execution facility" (DTEF) if it first finds that such action is "necessary to diminish, eliminate, or prevent" "sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity." However, the Commission's direct use of the authority conferred in Section 4a(a) is neither required nor justified if the relevant designated contract market has acted effectively to avoid "excessive speculation." Indeed, as the Commission has previously noted, the exchanges have the expertise and are in the best position to fix position limits for their contracts.¹⁰ In fact, this determination led the Commission to delegate to the exchanges authority to set position limits in non-enumerated commodities, in the first instances, almost 30 years ago.¹¹

Since that time, the regulatory structure for speculative position limits has been administered under a two-pronged framework; with enforcement of speculative position limits being shared by both the Commission and the DCMs.¹² Under the first prong, the Commission establishes and enforces speculative position limits for futures contracts on a limited group of agricultural commodities.¹³ Under the second prong, for all other commodities, individual DCMs, in fulfillment of their obligations under the CEA's Core Principles, establish and enforce their own speculative position limits or position accountability

provisions (including exemption and aggregation rules), subject to Commission oversight. The Commission has authority to enforce exchange-set speculative position limits, which it has approved, as violations of the Act.¹⁴ We do not believe that there is any reason to deviate from this effective framework.

The CFTC's authority respecting position limits is confined to futures contracts traded on U.S. DCMs, DTEFs and price discovery contracts (SPDC) traded on ECMs. The statutory definition of an SPDC is very limiting of the CFTC's authority and, so far the only SPDC is natural gas. As Chairman Gensler acknowledged in his recent Congressional testimony before the Senate Permanent Subcommittee on Investigations, in view of the various exclusions and exemptions from CFTC authority available for transactions executed in OTC market, the CFTC does not currently have authority to impose federally mandated position limits that would extend to the traditional bilateral OTC market.

Because the Commission has limited authority respecting the imposition of position limits across all markets in which positions in the same underlying commodity may be assumed, we believe that new self-imposed or CFTC-imposed restrictions on fully regulated DCMs likely will have the predictable and inevitable effect of simply shifting trading from regulated and transparent derivatives markets to less regulated markets such as ECMs, or unregulated, opaque markets, including, offshore Exchanges, offshore OTC Markets, U.S. physical markets and offshore physical markets, all of which are beyond the Commission's control respecting position limits. This result runs counter to the public interest and current efforts by the Administration and Congress to limit systemic risk in the financial system.¹⁵

¹⁰ 46 Fed. Reg. 50938, 50940

¹¹ Id.

¹² The Commission has consistently endorsed this framework when addressing issues related to speculative limits. See, e.g., 74 Fed. Reg. 12282; 72 Fed. Reg. 66097; 70 Fed. Reg. 12621; 69 Fed. Reg. 33874.

¹³ These "Federal limits" are enumerated in Commission regulation 150.2, and apply to the following futures and option markets: CBOT corn, oats, soybeans, wheat, soybean oil, and soybean meal; Minneapolis Grain Exchange (MGX) hard red spring wheat and white wheat; ICE Futures U.S. (formerly the New York Board of Trade) cotton No. 2; and Kansas City Board of Trade (KCBT) hard winter wheat. The exchanges, under their own rules, have adopted the Federal limits and enforce violations of these limits.

¹⁴ Violations of exchange-set speculative limits are subject to exchange disciplinary action; violations of exchange speculative limit rules approved by the Commission are subject to enforcement action by the Commission, in addition to any action that the exchanges may take.

¹⁵ This result also would seem contrary to the legislative intent underlying last year's legislation imposing new CFTC oversight on certain contracts traded on the essentially unregulated exempt commercial markets. Congress undertook this action after witnessing the results of the Amaranth experience. Using the market surveillance tool of position accountability levels, NYMEX staff members determined to direct Amaranth in August 2006 to reduce its open positions in the first two nearby contract months based upon what they believed to be a significant concentration in NYMEX markets in Natural Gas futures. However, this prudent regulatory action by the regulated futures exchange simply resulted in a shift of positions by Amaranth from NYMEX to the Intercontinental Exchange ("ICE"), which was undetectable at that time both by NYMEX and the CFTC.

Nonetheless, there are steps that the Commission and Congress may take to provide the CFTC with adequate authority to cure the problem it perceives. Specifically, Congress can expand the CFTC's power to cover certain U.S.-based behavior by amending the provisions of Section 2 of the CEA dealing with "excluded" commodities, as the term is defined in the CEA, to grant the CFTC authority to impose and enforce position limits on positions taken in excluded OTC transactions.

Moreover, the ECM category should be eliminated in order to subject these exchanges to the full panoply of the CFTC's authority respecting position limits. Indeed, any trading facility that is now successfully operating as an ECM can easily convert to a DTEF or DCM. A DTEF has an affirmative obligation to deter market abuses and to implement systems and procedures to comply with that obligation.¹⁶ DTEFs, however, are not explicitly obligated to comply with Core Principle 5. Thus, to ensure DTEFs take appropriate action respecting position limits the CFTC should make Core Principle 517 applicable to DTEFs trading enumerated or excluded commodities. The Commission has oversight powers to insure that these obligations are met. Once Core Principle 5 is applicable to DTEFs, this regulatory scheme would appear to provide an effective remedy to the problems identified with ECMs without the need to revise the current structure.

We caution, however, that any regulatory or legislative action aimed at constricting market activity without closing these regulatory gaps is likely to drive business to a more amenable jurisdiction or to unregulated markets; there is not likely to be a significant impact on the overall size of speculative and risk management positions. There will, however, likely be damage to the liquidity of the regulated markets with the attendant increases in costs to their users and, ultimately, U.S. consumers.

The United States has been the center of world trading because of its first mover advantage and its rational regulatory regime. If speculators and accumulators like swap dealers and index funds are restricted from trading world commodities such as oil and metals on U.S. exchanges and on the U.S. OTC market, their alternative is clear. They will turn to their foreign affiliates and the market will move offshore. Although Natural Gas delivered at Henry Hub is a natural U.S. product and it is not likely that that specific contract will move offshore, natural gas is a global product and it is certain that a new global benchmark contract will emerge on a foreign exchange if trading on U.S. markets is constricted by inappropriate limits. The likely chain of effects is predictable and unacceptable; liquidity of U.S. markets will be impaired causing damage to the domestic natural gas industry.¹⁸

Even if Congress or the Commission could find a legitimate basis to restrict or impede U.S. firms from participating in offshore markets, the only consequence will be to disadvantage U.S. firms and U.S. markets. World prices will be set without U.S. participation. Thus, the importance of precisely calibrated and properly administered position limits on energy contracts, along with a carefully managed exemption process, cannot be understated.

¹⁶ CEA Section 5a (c)(2) provides as follows: Deterrence of abuses — The board of trade shall establish and enforce trading and participation rules that will deter abuses and has the capacity to detect, investigate, and enforce those rules, including means to— (A) obtain information necessary to perform the functions required under this section; or (B) use technological means to— (i) provide market participants with impartial access to the market; and (ii) capture information that may be used in establishing whether rule violations have occurred.

¹⁷ Core Principle 5 of section 5(d) of the Act: POSITION LIMITATIONS OR ACCOUNTABILITY — To reduce the potential threat of market manipulation or congestion, especially during trading in the delivery month, the board of trade shall adopt position limitations or position accountability for speculators, where necessary and appropriate. (b) Acceptable practices. (1) In order to diminish potential problems arising from excessively large speculative positions, and to facilitate orderly liquidation of expiring futures contracts, markets may need to set limits on traders' positions for certain commodities.

¹⁸ Before the successful introduction of futures trading in 1983, the oil market had migrated through a series of non-competitive and non-transparent mechanisms for price determination. Before World War II, the Texas Railroad Commission oversaw production and price determination within the State of Texas. After the war, a corporate oligarchy — "the seven sisters"— organized a system for pricing based largely on netbacks to geographic points. In the early 1970s, OPEC, which was established in 1960, successfully asserted itself to take control of price determination. Though these three mechanisms were independent of each other, they shared two significant characteristics: prices were determined non-competitively and each process lacked transparency.

CME GROUP/NYMEX RESPONSE

We recognize that confidence in the markets may be undermined by the perception that speculators may be driving commodity prices. We also support the CFTC's mission to ensure that the energy markets subject to its regulation can operate efficiently to carry out their core missions. The vocal public criticism respecting the impact of "speculative" trading on energy commodities strongly suggests that the imposition of hard limits in such markets may increase confidence in the futures markets, and in the U.S. markets overall. The effort to increase confidence in the futures markets by imposing hard limits on energy products, however, must be delicately balanced with the need to ensure that such limits do not have a detrimental effect on the price discovery and hedging functions of futures markets. We believe that a carefully designed hard limits regime can accomplish these goals.

Accordingly, we make the following recommendations, which are described in more detail below.

- Each regulated exchange should set position limits for all months combined, single months and the delivery period based on traditional considerations, focusing on its open interest and, at or near the delivery period, the deliverable supply. The CFTC may alter or amend the limits set by an exchange or adopt a formula to be applied separately by each exchange based on factors pertinent to its market if it finds that the exchange's rules are inadequate to prevent the effects of "excessive speculation."
- Each exchange shall be responsible for administering its hedge exemption program for its markets subject to its existing exemption standards until such time as common exemption standards are established by the CFTC. Each exchange will continue to funds will remain eligible for risk management exemptions to hedge bona fide exposure but be subject to position limits for their speculative proprietary trading.

- The CFTC will establish a system for reporting of end-user OTC positions and, after gaining authority to impose aggregate limits that include OTC positions, be responsible for ensuring an end-user's combined on-exchange and OTC speculative positions do not exceed the aggregate total market position limit. The CFTC may grant exemptions for OTC positions that represent hedging rather than speculative activity.

We are prepared to lead, but any steps taken to impose hard position limits must support the national policy of enhancing transparent markets and central counterparty clearing — which was reaffirmed by Congress in its amendments to the CEA just last year — and prevent market participants from moving away from the best regulated, most transparent, safest marketplace to less regulated or even completely unregulated markets that are and will continue to be beyond the control of the Commission and Congress. Therefore, in conjunction with our adopting a hard limits regime, ECMs and FBOTs must do so as well for all similar contracts. As previously noted, if these entities are not subject to a hard limit regime for all similar products, not just SPDC, hard limits at NYMEX will simply bleed business into unregulated or less regulated venues. Additionally, placing DCMs, ECMs and FBOTs on equal footing with respect to position limits will ensure that market competition among these trading platforms is based on liquidity, technology, clearing quality, price and customer service, and not regulatory arbitrage.

Moreover, it is essential that the exchanges be permitted to continue to administer exemptions from the speculative limits for risk mitigating trades. The imposition of hard position limits, absent a hedge exemption for swap dealers and index funds, on a U.S. futures exchange with respect to a commodity that trades on a global basis, that is readily stored, that has numerous dedicated exchanges and a number of well-established OTC trading venues is unlikely to have any significant commercial impact other than driving the prohibited positions off-exchange or to venues outside the United States with predictable harm to the U.S. regulated markets and their users (e.g., commercials, producers, consumers). Thus, it is essential that swap dealers and index funds be allowed a risk offset exemption.

Position Limits – Calibrated To Existing CFTC Authority

NYMEX currently employs hard position limits during the last three days of trading before the delivery period begins and position accountability levels at other times to avoid congestion and other market disrupting events that may flow from excessive concentrations of positions. NYMEX’s administration of its accountability regime has been discredited in the press simply by listing the number of traders who, and time periods during which, such traders held positions in excess of the accountability levels. Of course, current accountability levels are set as an early warning alert well below the level at which position concentrations present a market integrity concern. Consequently, traders frequently hold positions in excess of those levels for extended periods. For example, NYMEX’s accountability limits are set as a small percentage of the front month’s open interest:

NYMEX Contract	Single-Month Accountability Level	Percentage of Front Month Futures-Equivalent Open Interest
Crude Oil	10,000	3%
Natural Gas	6,000	4%
RBOB Blendstock Gasoline	5,000	6%
Heating Oil	5,000	7%

It is well-understood in the industry and among CFTC staff that traders can and do hold positions in excess of the accountability levels without adversely impacting prices or volatility. The CFTC has repeatedly found that the NYMEX’s administration of its accountability levels is in compliance with its obligations under the CEA to prevent excessive speculation, as interpreted by the CFTC in its “Acceptable Practices” for Core Principle 5. Notwithstanding the success of NYMEX’s accountability regime, as previously noted, we recognize that concerns have been raised about accountability regimes for the energy products and such concerns may be impacting confidence in our markets. We are committed to working with the Commission and other market participants to address these issues in a way that ensures continued market integrity and competition among the markets. To this end, if those ECMs and FBOT that trade energy products agree to adopt comparable programs, we will adopt hard limits for

energy contracts, in addition to the current limits that apply during the last three trading days of the expiration month, which will include single-month and all-months combined limits as well as concentration ratio thresholds. This modified regime will include the administration of tailored hedge exemptions for swap dealers and index funds, that reflect the individual circumstances of the participants and are limited in duration and quantity, and as whole, should alleviate external concerns that positions held by these investors and hedgers will increase price volatility or artificially inflate or deflate prices.

Each exchange and ECM, which is obligated to control excessive speculation, has an obligation under the CEA to set its own limits in proportion to liquidity, volume, open interest and other factors respecting trading for which it is directly responsible. It is contrary to the purposes of the CEA’s prohibition on excessive speculation for an exchange with limited liquidity, volume and/or open interest to simply mimic the position limits set by the exchange on which it is attempting to free ride. For example, if NYMEX with substantial volume, open interest and liquidity, sets its single-month position limit at 20,000 and an exchange with one-fourth of NYMEX’s liquidity, volume and open interest, simply expropriates that number, traders would be able to exploit a position limit of 40,000 when the correct level should have been 25,000 with no more than 20,000 on NYMEX and 5,000 on the less liquid exchange.

Proposed Principles For Single Exchange Position Limits For Energy Contracts

Spot Limit: During a short period beginning near the termination of trading in a contract (last three days in energy) setting the position limit at 25 percent of deliverable supply for a physically delivered contract is well-established and appropriate for the purposes of minimizing the potential for manipulation and allowing for effective convergence of futures and cash. Financially-settled contracts referencing the physically-settled contract should have an equivalent, but separate, spot limit.

Single-Month and All-Months Combined Limits: Single-month limits should be a function of liquidity as the objective is to limit the potential for the initiation or liquidation of a large position to cause price distortions. Our experience suggests that futures-equivalent open interest in the lead month is an appropriate proxy for liquidity on each exchange. We suggest that the single-month limit be established as 10 percent of the first 25,000 contracts of open interest with a 5 percent marginal increase for open interest in excess of 25,000 at each exchange – DCM, ECM or FBOT; the all-months-combined limit would be 150 percent of the single-month limit and the all-months limit would also be applicable to spread positions within the same contract. Additionally, for physical and financially settled contracts based on the same underlying commodity and traded on the same exchange, the open interest (adjusted for contract size) will be calculated across the products and a single aggregate limit will be established for the full complement of such contracts.

This methodology allows for natural limitations of concentration in excess of levels that a market can appropriately handle without risk to the integrity of the market. This methodology also produces a natural aggregate limit across exchanges that is fairly applied and which fosters competition. It also produces a self-correcting limit level based on periodic, sustained changes in open interest, and is accomplished without requiring CFTC resources and intervention in administering exchange limits.

Concentration: Concern that position limits calculated according to this formula will permit excessive concentration in some thinly traded contract months will be addressed by including, on top of the position limits, a flexible concentration ratio threshold, which will be calculated on the basis of open interest in a single month. These concentration thresholds will protect against the potentially disruptive effects of excessive concentration by a single trader and allow the exchange to direct a trader not to increase his position or to reduce his position. The concentration ratio threshold will be flexible enough to accommodate the development of liquidity in deferred month contracts and also to ensure that participants can manage their positions appropriately. Our proposed concentration threshold is 25 percent of open interest in a single month that has developed liquidity.

Proposed Principles For Position Limits – Cross-Market Aggregation

If the CFTC gains authority over OTC trading, and if it finds a means to minimize the impact of transfers of trading to foreign jurisdictions or to some variation of the cash/physical market, then the CFTC should adopt an aggregate limit for the total positions held in all of the markets and apply the aggregate position limit at the level of the actual position owner/controller in accordance with the provisions of CFTC Regulation 150.4 respecting aggregation. The CFTC-set aggregate limits would be set in terms of equivalents of the largest most liquid futures contract. For example, the light sweet crude oil limit would be set in terms of equivalents to the NYMEX contract WTI specification, or 1,000 barrels per contract. In addition to the aggregate limit, each regulated exchange would continue to be responsible for enforcing its exchange-specific limits.

In order to properly enforce aggregate limits, each of the ultimate customers would need to be identified and its total derivatives position, including U.S. futures, FBOT futures, SPDC, ETFs and OTC contracts would be aggregated. The CFTC would identify traders whose aggregate speculative on-exchange and related OTC positions exceeded the CFTC aggregate limit and would be responsible for enforcing compliance with the aggregate limit. The CFTC would also grant exemptions for OTC positions that qualified for hedge treatment.

Assume that the one month aggregate limit for WTI was set by the CFTC at 40,000 contract equivalents. A trader would be entitled to accumulate and hold derivative contracts covering 40,000,000 barrels. That trader would also be constrained by position limits set by DCMs and ECMs. For example, based on open interest, the trader might be entitled to hold 20,000 contracts at NYMEX and 5,000 at ICE. The remaining 15,000 contract equivalents could be held in some combination of ETF shares, OTC swaps and FBOT contracts. Traders will be responsible for reporting their OTC positions directly to the CFTC. The CFTC would be responsible for requiring the trader to reduce its positions, but would not take an action that favors a particular venue.

CONCLUSION

Regulated futures markets have played an integral role in the economic life of this country for almost 100 years and, increasingly, are playing a critical role in the world economy. Futures markets permit those who seek to minimize risk to quickly and efficiently find those willing to take on that risk. While we understand that futures markets must instill confidence in all key stakeholders, it is also important to recognize that changes made to ensure public confidence without comprehensive analysis of the potential effects, may undermine otherwise well functioning markets that have earned their status as global benchmarks for price discovery and risk management. Confidence clearly will not be enhanced by measures that impair liquidity and efficiency and that incentivize traders to utilize less transparent or offshore venues. We believe the approach outlined in this White Paper addresses public concerns and protects the competitiveness and transparency of our domestic energy markets. We look forward to working with the CFTC, Congress and other registered exchanges to put these recommendations into practice.



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