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Top U.S. Regulator Approves New Limit on Commodity Speculation in 3-2 Vote

By Asjylyn Loder and Silla Brush - Oct 18, 2011 11:10 PM GMT+0100

The top U.S. derivatives regulators voted 3 to 2 today to curb trading in oil, wheat, gold and other commodities after a boom in raw-materials speculation, record- high prices and years of debate and delay.

The rule has been among the most controversial provisions of the Dodd-Frank financial overhaul, enacted last year, which gave the Commodity Futures Trading Commission the authority to limit trading in over-the-counter commodity swaps as well as exchange-traded futures. The rule will limit the number of contracts a single firm can hold.

“Our duty is to protect both market participants and the American public from fraud, manipulation and other abuses,” Chairman Gary Gensler said at the commission’s meeting in Washington in support of the rule. “Position limits have served since the Commodity Exchange Act passed in 1936 as a tool to curb or prevent excessive speculation that may burden interstate commerce.”

The rule limits traders to 25 percent of deliverable supply in the month nearest to delivery. The spot-month limits apply separately to physically settled and cash-settled contracts. Deliverable supply will be determined by the CFTC in conjunction with the exchanges.

Gas Contracts

Cash-settled natural gas contracts will be subject to a different regime. Traders will be permitted to hold contracts equal to five times deliverable supply in Henry Hub swaps, derivatives that settle in cash instead of the delivery of the underlying commodity. Henry Hub is a natural gas delivery point in Erath, Louisiana, and the benchmark for U.S. futures.

Outside the spot month, the caps limit traders to 10 percent of the first 25,000 contracts of open interest and 2.5 percent thereafter.

"You want speculation or you don't have any markets," said Commissioner Bart Chilton in an interview today on Bloomberg TV. "There's nothing wrong with speculators. It's when it begins to get excessive. We've seen where you can have 30, 35, 40 percent plus in some markets with just one trader holding onto that concentration. That can impact markets."

The commission estimates that the limits will affect 85 energy traders, 12 metals traders and 84 traders of certain agricultural contracts. The caps will go into effect 60 days after the agency defines the term "swap." The agency declined to estimate when that will be. Limits outside the spot month are likely to go into effect in late 2012.

Affected Contracts

The limits will apply to 28 physical commodity futures and their financially equivalent swaps including contracts for corn, wheat, soybeans, oats, cotton, oil, heating oil, gasoline, cocoa, milk, sugar, silver, palladium and platinum.

The rule calls for traders to aggregate their positions, a change that may affect large firms with multiple strategies. It also would tighten an exemption allowing so-called bona fide hedgers to exceed the caps.

"Today is no doubt the single most significant vote I have taken since becoming a commissioner," said Commissioner Jill Sommers, who voted against the rule. "Not because imposing position limits will fundamentally change the way the U.S. markets operate, but because I believe this agency is setting itself up for an enormous failure."

The close vote split along party lines, with the three Democrats, including Gensler, voting in favor and the two Republicans against.

No Proof

Commissioner Michael Dunn, a Democrat, said position limits are a "sideshow," and there's no proof that there is excessive speculation, or that prices will drop once limits are in place. Dunn said he voted in favor of limits because Congress directed the commission to impose caps.

"Things will remain relatively the same, except for those who use the markets we regulate to provide the very resources we all need," Dunn said. "For these farmers, producers and manufacturers, position limits, and the rules that go along with them, may actually make it more difficult to hedge the risks they take on in order to provide the public with milk, bread and gas."

The Dodd-Frank legislation gave the commission jurisdiction over the estimated $300 trillion U.S. derivatives market and the CFTC has proposed more than 50 rules. The agency missed deadlines to impose position limits in energy and metals markets by mid-January and agricultural markets by April.

Economic Impact

"I recognize there are passionate views on both sides, especially with regard to position limits, but our role is to make decisions on policy in a dispassionate manner that is rooted in facts," Commissioner Scott O'Malia, a Republican, said. Parts of the rules are arbitrary and vulnerable to legal challenge and may have a substantial economic impact on market participants, he said.

Senators Carl Levin, a Michigan Democrat, Maria Cantwell, a Washington Democrat, Bill Nelson, a Florida Democrat, and Bernie Sanders, a Vermont independent, have criticized the agency for the delay.

Levin, chairman of the Permanent Subcommittee on Investigations, had scheduled a hearing on Oct. 6 to scrutinize the CFTC's compliance with the position limit requirement. He delayed the hearing to Nov. 3 after the agency said it would vote on the regulations as early as today.

Middle-Class Families

"The position limits rule approved today by the CFTC represents significant progress for middle-class families facing roller-coaster gasoline, electricity, and food prices," Levin said today. "Businesses that actually use commodities -- farmers, manufacturers, airlines -- will not be affected and will continue to operate free of position limits."

Levin's committee has led inquiries into speculation in the past five years as raw-material investing gained in popularity. The first exchange-traded funds in 2003

allowed investors to bet on raw materials without the hassle of storing physical materials or managing a futures account.

The SPDR Gold Trust, best known by its ticker GLD, went on the market in 2004 and has $66 billion in assets backed by physical gold. Investment in agricultural exchange-traded products reached a record in April, according to data compiled by Bloomberg.

Derivatives made the boom possible. Unlike futures contracts, which trade on regulated exchanges and fall under CFTC jurisdiction, swaps trade on the over-the-counter market where the commission had no authority before Dodd-Frank, allowing traders to amass large unregulated positions.

'Too Big'

"The fund participants have been able to grow too big and trade the markets without regard to the underlying fundamental supply and demand factors," said Roy Huckabay, an executive vice president for the Linn Group, a research and brokerage firm in Chicago. "The market's job of price discovery had been forgotten or ignored."

Off-exchange bets played a role in the September 2006 collapse of Amaranth Advisors LLC, a hedge fund that lost $6.6 billion on natural-gas bets. The Greenwich, Connecticut-based fund had sidestepped limits and built a large position on IntercontinentalExchange Inc. (ICE) after being told to reduce its futures position on the New York Mercantile Exchange.

Amaranth's implosion triggered Senate scrutiny. In June 2007, the Senate Permanent Subcommittee on Investigations issued a report blaming Amaranth for distorting prices. Amaranth later paid $7.5 million to settle CFTC allegations of manipulation.

Record Prices

Rising commodity prices kept Congress and consumers focused on market regulation and the role of speculators. Wheat reached a record of $13.495 a bushel in February 2008, and oil soared to $147.27 a barrel five months later. Gold futures hit an all-time high of $1,923.70 last month.

“This is not going to affect prices so I would call this a non-event,” Frank McGhee, the head dealer at Integrated Brokerage Services LLC in Chicago, said in a telephone interview today. “But ultimately it’s not good for the U.S. market as the people they are trying to regulate can selectively decide which market they want to trade in.”

The commission’s decision also was criticized today by a leading Republican member of Congress.

“I am concerned the rule will unnecessarily restrict hedging by our agricultural and energy producers, the very hedging that helps them stabilize the costs of food, fuel and power, and may very well exacerbate price volatility rather than reduce it,” said Congressman Frank Lucas, an Oklahoma representative who is chairman of the House Agriculture Committee.

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