In Defense of Hedging

The Debate on Position Limits

By Joanne Morrison

ON DEC. 9, the Commodity Futures Trading Commission held a public meeting of its Agricultural Advisory Committee. More than 30 people representing a broad swathe of agricultural groups, ranging from grain producers to cattle ranchers, discussed one of the most difficult and intractable policy issues now facing the agency—how to respond to political demands for tougher limits on speculation while preserving the ability of farmers and other end-users to hedge their risks in the futures markets.

The CFTC's Agricultural Advisory Committee held an all-day meeting in December to discuss position limits and other rules.

Photos by Jonathan Ernst

Ever since the dramatic rise and fall of oil prices in 2008, the CFTC has been under pressure to tighten the limits on the number of futures contracts that speculators can hold. When Congress drafted the Dodd-Frank Act in 2009 and 2010, Democratic lawmakers called for a crackdown on excessive speculation and added a section to the law directing the CFTC to rewrite its speculative position limits rules and extend them to a wider range of commodities. The CFTC has found it extraordinarily difficult to meet this mandate, however. Under former CFTC Chairman Gary Gensler, the agency issued a draft rule in January 2011. After receiving thousands of comment letters—higher than any other rulemaking in the agency's history—the CFTC approved a final version in October 2011. That rule was challenged in court, however, and in September 2012 the rule was overturned and the CFTC was forced back to the drafting table. Today the agency continues its work to finalize a new version of the rule, but the climate has changed. The Democrats are no longer in control of Congress and many lawmakers are calling for changes to Dodd-Frank. Equally important, three out of the four commissioners now serving at the agency—including the chairman, Timothy Massad—entered office in 2014, well after the current version of the proposal was issued in November 2013.

Massad and his colleagues continue to press ahead with the proposal, but there is now a greater emphasis on preserving the ability of end-users to hedge their risks. This new emphasis was on full display at the December meeting. CFTC staff and commissioners listened attentively as farmers, ranchers and producers representing nearly every aspect of the U.S. agricultural sector warned that several parts of the current proposal would severely impair their ability to use the futures markets to hedge their risks.

Narrow Definition

The participants expressed particular concern about the new definition of *bona fide* hedging in the current proposal. This definition would exclude a large number of frequently used hedging strategies, such as locking in futures spreads, hedging delayed price commitments and anticipatory hedging of processing capacity, they said. Since positions limits only apply to speculative trading, any trading strategies that fall outside the definition of *bona fide* hedging would become subject to position limits, which they said would have the effect of curtailing previously common and recognized hedging strategies. "We've got a lot of legitimate risk-reducing activity that we use the exchange for right now. It's not currently being treated as *bona fide* hedging here," said Lance Kotschwar, a compliance attorney at Gavilon Group, who spoke on behalf of the Commodity Markets Council. For example, a grain elevator might establish a position in wheat futures ahead of the spring planting to lock in a price for the upcoming crop year. The elevator expects to make money by storing wheat

after the harvest and uses the futures to hedge the risk of a bad harvest and lower than expected need for storage. At the time of the trade, the elevator may not have had any grain in storage; the trade was made to hedge a risk that will not actually materialize until later in the year. This type of anticipatory hedging is a well-established practice in the agricultural industry, according to the National Grain and Feed Association and other agricultural groups. But the proposed redefinition of *bona fide* hedging would exclude this type of trading strategy. That could cause some hedgers to move away from the futures markets and look for alternatives such as forwards, according to M.J. Anderson, an executive with the Andersons Grain Group who spoke on behalf of the NGFA. "If you limit participation in the futures market you may blur some of the signals to the producer on what he needs to be growing, which could lead to a supply disruption down the road," Anderson said. This in turn will have an effect on price discovery.

Massad said the CFTC is working to develop an appropriate definition of *bona fide* hedging for the purpose of applying position limits, but he did not describe the agency's thinking on this issue in detail. In an appearance a day later before the Senate Agriculture Committee, he discussed the challenges the agency is facing in defining what constitutes a *bona fide* hedge.

"Position limits are a very important tool in the toolkit to address excessive speculation. But at the same time, we have to make sure we allow for *bona fide* hedging," Massad told the Senate committee on Dec. 10. "The question is, how do you draw the bright lines that distinguish between true *bona fide* hedging by commercial players versus what speculators might do?"

Deliverable Supply and Convergence

The participants also discussed another issue of particular concern to agricultural interests—a proposed change to the CFTC's methodology for setting position limits. The existing limits for the spot month are set at 25% of the estimated deliverable supply of the underlying commodity. Under the current proposal, spot month position limits would be reset every two years and exchanges would be required to submit an updated estimate of deliverable supply at least once every two years. The reliance on deliverable supply estimates is not a new policy. For decades the CFTC's position has been that deliverable supplies need to be sufficiently large so that the delivery process drives an appropriate convergence of cash and futures prices. In this context deliverable supply means the amount of the underlying commodity that can be expected to be readily available to traders at its market value

JULY 2008 ›

In response to rising energy and food prices, a bipartisan group of Senators including Maria Cantwell (D-Wash.), Susan Collins (R-Maine) and Joseph Lieberman (I-Conn.) sponsored legislation to curb "excessive speculation" by limiting the number of commodity futures and swaps that can be held by speculators. The bill was not enacted, but set the groundwork for position limit language to be included in broader financial reform legislation two years later.

JULY 2010 ›

Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act. The law includes language directing the CFTC to set speculative position limits for exchange-traded and over-the-counter derivatives on a wide range of physical commodities.

JANUARY 2011 ›

The CFTC issued its first proposed position limit rule. The rule set speculative position limits for futures and options on 28 commodities as well as swaps that are "economically equivalent."

OCTOBER 2011 ›

The CFTC finalized the position limit rule by a vote of 3-2, with two Republican commissioners at the agency in opposition. Democratic Commissioner Mike Dunn voted for the rule, but questioned its rationale. The rule was set to begin taking effect in the second half of 2012, allowing the agency time to collect the data necessary to determine position limit levels.

Curtis Friesen spoke on behalf of the National Corn Growers Association.

and in the normal marketing channels. A change could result in a significant increase in limits, because deliverable supply estimates have not been reset in many years. What is new is the frequency and size of changes to the limits. Given current estimates of deliverable supply, several participants commented that the proposal would have the effect of resetting position limits far above the levels currently set by the four U.S. exchanges that list futures on corn, wheat and 17 other agricultural commodities.

While the exchanges are not required to match the federal position limits and have the ability to set limits lower than the proposed levels, agricultural users are worried that the CFTC might override the exchange-set limits if it determines that the deliverable supply estimates provided by the exchanges are not "reasonable." More generally, they expressed concerns that the proposal could significantly and quickly increase limits and ultimately open the door for large flows of speculative trading into the agricultural futures markets and disrupt the convergence of cash and futures prices. The limits now imposed by the exchanges have been determined through extensive consultation with the industry, the participants explained, and any changes could disrupt the convergence between the price of an underlying commodity market and the price of the futures contracts as they approach expiration. "It's hard for me to overstate how seri-

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SEPTEMBER 2012 ›

A federal court struck down the CFTC's position limit rule. The court found that the CFTC "fundamentally misunderstood" the relevant provisions of Dodd-Frank. The rule had been challenged by two trade associations, the International Swaps and Derivatives Association and the Securities Industry and Financial Markets Association, which argued that the CFTC's rulemaking process was "procedurally flawed" and did not sufficiently assess the rule's costs and benefits.

NOVEMBER 2013 ›

The CFTC issued new position limit and position aggregation proposals that addressed some of the procedural issues that were the focus of the legal challenge. The new proposals also contained a revised definition of bona fide hedging that narrowed the range of trading activities deemed as legitimate hedging, raising concerns among end-user groups.

JUNE 2014 ›

After hosting a special roundtable discussion with market participants, the CFTC extended the comment period for its proposed position limit and position aggregation rules.

DECEMBER 2014 ›

The CFTC re-opened the comment period for the proposed position limit rule after hearing concerns raised by end-user groups at a meeting hosted by the CFTC's Agricultural Advisory Committee.

M.J. Anderson, who spoke on behalf of the National Grain and Feed Association, and Edward Gallagher of the National Milk Producers Federation, participate in the roundtable discussion.

AGRICULTURAL INTERESTS ENDORSE PROPOSED CHANGES TO CFTC'S RESIDUAL INTEREST RULE

Doris Mold, a dairy farmer representing American Agri Women, was one of many end-user representatives discussing CFTC rules.

At a Dec. 9 meeting of the Commodity Futures Trading Commission's Agricultural Advisory Committee, agricultural sector groups discussed the challenges with the agency's so-called residual interest rule. This rule is part of a package of customer protection rules that were finalized in October 2013 and began taking effect early last year.

The CFTC's residual interest rule sets a tighter deadline for futures commission merchants to fund under-margined customer accounts. The current deadline under the rule is now set to 6:00 p.m. on the day of settlement, which is generally referenced as "T plus 1, close of business." The rule was developed along with a package of other customer protections in response to the collapses of MF Global and Peregrine Financial. (See "CFTC's Customer Protection Measures Draw Opposition" in the November 2013 issue of *Futures Industry*)

Under the CFTC rule, this deadline was set to change automatically in December 2018 to an earlier time of clearinghouse settlement, but in November 2014, the CFTC proposed a rule clarifying that the deadline would not be moved any earlier without CFTC rulemaking action. This change was welcomed by participants on the advisory committee as well as by lawmakers representing farm belt states, but there remain concerns that this residual interest rule will be costly, particularly for smaller hedgers and producers.

Driving End-Users Out of Market

Curtis Friesen, representing the National Corn Growers Association, said that a tighter deadline could require that a futures commission merchant have direct access to a customer's account and warned that this would drive corn growers out of the futures markets. He also suggested that FCM customers who are *bona fide* hedgers should be treated differently than speculators with respect to residual interest.

"I don't think we've caused a bankruptcy with an FCM or anything like that," said Friessen, a fourth generation corn grower and local Nebraska politician. "I will quit using futures positions. I will find some other way to hedge my grain." He and other end-users have raised concerns over FCMs holding additional customer funds in the wake of the MF Global and Peregrine collapses.

Tom Smith, acting director in the CFTC's division of swap dealer and intermediary oversight, repeatedly asserted that the intent of the CFTC rule is to ensure that if there is an under-margined account at an FCM, it will not be covered by another customer's funds.

"We have to take into account what the statute provides," said Smith. "The statute does provide that a futures commission merchant can't use the funds of one customer to margin or guarantee positions of any other person… if there is an under-margined account at the FCM that needs to be covered in one way or another."

Tom Kadlec, president of ADM Investor Services, who spoke on behalf of FIA, said his firm is working through the challenges of the current T plus 1 deadline. "It's imperative that we calculate the costs and the effects on all of our customers," he said. He added that he would be willing to participate in the CFTC's study on the feasibility of moving the residual interest deadline earlier.

A Big Change for Customers

For FCMs like CHS Hedging, the residual interest rule is a big change for their customers, most of whom are farmers and ranchers. "We have to deal with a lot of folks that still deal with checks," said Scott Cordes, who heads up CHS Hedging. He asserted that while the current T plus 1 deadline is working, participants need time. "This is a topic that's going to need to see some further review as we go," he said, questioning how the tighter deadlines would work in times of market stress. "I would like to see some more results when we get a major market move… I'd like to see what happens when we go from $5 corn to $7 corn to see what stress we put on our systems."

Under current rules, the CFTC requires that before customer funds are returned each day, the FCM must do its daily segregation calculation. "The intent is that we want to make sure that there are sufficient funds at the firm before withdrawals are made," Smith said.

Cordes cautioned CFTC officials to consider how FCMs manage excess funds of customers, warning that the residual interest requirements could cause delays in the flow of funds back to customers.

"We've got to be able to send the money back to the people it belongs to, not say we have to hold it up for a delay because it's going to impact us on a regulatory item," Cordes said.

— By Joanne Morrison, deputy editor

ous convergence is to our members. When there are convergence problems, it's a serious problem," said John Anderson, deputy chief economist with the American Farm Bureau. While the participants agreed that deliverable supply should be monitored on a more frequent basis, they argued against frequent recalculations of position limit levels. Bryan Dierlam, director of government affairs at Cargill, cautioned officials against automatically going through a mechanical process of changing the limits every few years. This is not necessary if the markets are working appropriately, he said. "I think what you want to know is: are the markets working? Is there convergence?" Joe Kovanda, an executive with a Kansas City cattle producer who spoke on behalf of the National Cattlemen's Beef Association, added that the CFTC should rely on the exchanges to monitor market conditions and set spot month position limits. CFTC Commissioner Chris Giancarlo asked CFTC staff what the logic was behind setting limits at 25% of deliverable supply and whether this limit was still appropriate. Steven Sherrod, senior economist in the CFTC's division of market oversight, responded that the 25% limit has been "a rule of thumb" used since the 1930s. CFTC officials also noted that spot limits imposed by exchanges are normally lower than the CFTC's 25% threshold.

Unnecessary Burdens

Agricultural interests are far from the only industry groups that have expressed concerns about the position limits proposal, but their voice carries particular clout at the CFTC. One reason is that the U.S. agricultural futures markets are already subject to federal position limits, unlike most other commodity futures markets in the U.S., which have exchange-set limits. The agricultural representatives at the December meeting therefore could speak with authority on what has worked well in the past and why the proposed changes would be harmful. Another reason is their voice resonates with the House and Senate agriculture committees that oversee the CFTC.

That may explain why the new leadership at the CFTC has been careful to acknowledge their concerns. Massad signaled his interest in agricultural concerns by naming himself as the sponsor of the agricultural advisory committee and promising to hold meetings every six months. While the advisory committee has no authority to set rules, it does provide an opportunity for market participants to raise their concerns directly with CFTC officials. Massad also has vowed to protect the ability of farmers, ranchers and others to effectively hedge their risks in the futures markets, and reopened the comment period on the position limits proposal to gather more input on agriculture-related issues. "Our goal is not to create unnecessary burdens on commercial end-users but to build a reliable, orderly framework for oversight in which vibrant markets can thrive," he told the members of the advisory committee meeting.

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