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## The CFTC's Attempt to Impose Speculative Position Limits on Off-Exchange Swap Contracts Likely to Face Continued Legal Challenge

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## THE CFTC'S ATTEMPT TO IMPOSE SPECULATIVE POSITION LIMITS ON OFF-EXCHANGE SWAP CONTRACTS LIKELY TO FACE CONTINUED LEGAL CHALLENGE

*Bob Bernstein\**

The Commodity Futures Trading Commission (“CFTC”) is once again seeking to enact sweeping mandatory position limits, intended to curb what it regards as “excessive speculation” in privately negotiated swaps, involving twenty-eight different physical commodities that are traded on United States designated futures markets.<sup>1</sup>

The CFTC claims that the authority to do this is based on amendments to the Commodity Exchange Act that were adopted as part of the Wall Street Transparency and Accountability Act of 2010 (“Dodd- Frank”).<sup>2</sup>

The twenty-eight commodities that would be subject to off-exchange position limits include Comex copper, silver and gold, NYMEX gasoline, low sulfur diesel, light sweet crude, natural gas, platinum and palladium, and a variety of agricultural products traded on the Chicago Board of Trade, the Chicago Mercantile Exchange, and ICE Futures U.S. (cocoa, coffee, orange juice).

Excluded from the proposal are position limits for swaps in physical commodities other than the twenty-eight commodities specifically identified, as well as swaps in non-physical commodities, such as interest rates, foreign exchange, and commodity indices.<sup>3</sup>

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\* Mr. Bernstein is a partner in the law firm of Eaton & Van Winkle LLP in Manhattan. He recently represented U.S. copper fabricators opposed to the launch of new exchange traded funds backed by physical copper. The proposals have since been withdrawn.

<sup>1</sup> *Position Limits for Derivatives*, COMMODITY FUTURES TRADING COMM’N 95 (proposed Nov. 5, 2013), <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister110513c.pdf> (last visited May 2, 2014). This proposal was published in the Federal Register on Nov. 15, 2013.

<sup>2</sup> 15 U.S.C § 8302 (2010).

<sup>3</sup> *Position Limits for Derivatives*, *supra* note 1, at 18 n.49. As proposed, it would appear that swaps denominated in contracts traded in the United States on foreign boards of trade, such as the London Metal Exchange, where most metal futures in the United States are actu-

A position limit caps the maximum number of derivative contracts to purchase (long) or sell (short) that an individual trader or group of traders may own during a given period.<sup>4</sup> The proposed limits would cap the number of such contracts a trader may hold in both the spot month, which is a specific period of time that immediately precedes the date of delivery of the commodity under the derivatives contract and in non-spot months, by capping the total number of contracts that expire in periods further in the future or in all months combined.<sup>5</sup>

Here, the CFTC is proposing that position limits in the spot month for each such commodity should generally be limited to 25% of the estimated deliverable supply of that commodity, which is defined as the amount of such physical commodity that can reasonably be expected to be available to accommodate a short seller needing to make physical delivery.<sup>6</sup> That would include the amount of such physical commodity actually stored in any exchange warehouse designated for such delivery, plus anything else that could reasonably be expected to arrive in time to meet a delivery obligation that month.<sup>7</sup>

In the non-spot months, the CFTC is proposing to limit the

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ally traded, would be exempt from CFTC position limits. The LME operates without position limits. It, therefore, follows that one of the unintended consequences of the CFTC proposal may be to give competing exchanges that operate in the United States as foreign boards of trade a competitive advantage over their United States competitors by ensuring their futures markets operate with far greater liquidity. In recognition of this possibility, Dodd-Frank says the CFTC “shall strive to ensure that trading on foreign boards of trade in the same commodity will be subject to comparable limits and that any limits to be imposed by the Commission will not cause price discovery in the commodity to shift to trading on the foreign boards of trade.” 7 U.S.C. § 6a(2)(C). The CFTC does not appear to have addressed the issue at this time.

However, efforts are underway in the European Union to adopt comparable position limits to curb so-called “excessive speculation.” In January 2014, the European Parliament approved the concept of position limits, but the determination of what those limits will be, what underlying products will be covered, whether such limits will be applicable to off-exchange as well as exchange-traded derivatives, and what exemptions will be available for hedging purposes, are all still to be negotiated, and there is no assurance such regulations will be applicable or acceptable by all countries in the European Union, including in particular in the United Kingdom. Jim Brunsten, *EU Reins In High-Frequency Traders to Commodity Speculators*, WASH. POST (Jan. 15, 2014, 10:09 AM), <http://washpost.bloomberg.com/Story?docId=1376-MZEW996K50YR01-18HPPOQOIB6AK99QAVN6G50NS>.

<sup>4</sup> 17 C.F.R. § 150.2 (2012).

<sup>5</sup> *Position Limits for Derivatives*, *supra* note 1, at 301-02.

<sup>6</sup> CME GROUP, CONDITIONAL SPOT-MONTH SPECULATIVE LIMIT PROPOSAL (2011), *available at* [http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission\\_080211\\_964\\_0.pdf](http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission_080211_964_0.pdf).

<sup>7</sup> *Position Limits for Derivatives*, *supra* note 1, at 170-71.

number of contracts a speculator may acquire in a single month, or in the aggregate, to 2.5% of the open interest in such contracts up to the first 25,000 contracts and 1.2% of the excess above 25,000 contracts.<sup>8</sup>

The first question one might well ask is whether sweeping new rules to combat off-exchange “excessive speculation” are even needed. There were numerous events that led to the economic crisis in 2008 and subsequent passage of the Dodd Frank Act,<sup>9</sup> but on or off-exchange “excessive speculation” in commodities is not usually identified as one of them.<sup>10</sup>

The next question is whether these new rules are likely to withstand judicial review if, as the CFTC maintains in its latest public filing, there is no obligation to demonstrate that these new rules are even necessary much less demonstrate through any quantitative analysis that their putative benefits outweigh the costs.<sup>11</sup>

Thus, the Commission stated in its latest notice that “it is reasonable to conclude from the Dodd-Frank amendments that Congress mandated limits and did not intend for the Commission to make a necessity finding as a prerequisite to the imposition of limits.”<sup>12</sup>

At issue here is the entire concept in the United States of “excessive speculation.”<sup>13</sup> Those who favor imposing these sweeping new position limits believe, as a matter of faith, that “excess” speculation in futures markets artificially inflates prices for the physical commodities underlying those trades, thereby burdening interstate commerce in the United States.<sup>14</sup> They point to examples in history

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<sup>8</sup> *Id.* at 178.

<sup>9</sup> YU GAO ET AL., THE ECONOMIC IMPACT OF THE DODD FRANK ACT OF 2010: EVIDENCE FROM MARKET REACTIONS TO EVENTS SURROUNDING THE PASSAGE OF THE ACT 6-7 (2011), available at [http://business.rice.edu/uploadedFiles/Faculty\\_and\\_Research/Academic\\_Areas/Accounting/papers/Wang\\_Paper.pdf](http://business.rice.edu/uploadedFiles/Faculty_and_Research/Academic_Areas/Accounting/papers/Wang_Paper.pdf).

<sup>10</sup> *Id.* at 14.

<sup>11</sup> Prohibitions and Restrictions on Proprietary Trading, 79 Fed. Reg. 5808, 5813 (Jan. 31, 2014).

<sup>12</sup> *Position Limits for Derivatives*, *supra* note 1, at 11; *id.* at 21-22 (“Because of this mandate, the Commission need not make a prerequisite finding that such limits are necessary ‘to diminish, eliminate or prevent excessive speculation causing sudden or unreasonable fluctuations or unwarranted changes in the prices of’ commodities under pre-Dodd Frank CEA section 4a(a)(1).”).

<sup>13</sup> 7 U.S.C. § 6a (2010). The same can be said of the concept in Europe, which, like the United States, is also proposing position limits to combat “excessive speculation.”

<sup>14</sup> CME GROUP, EXCESSIVE SPECULATION AND POSITION LIMITS IN ENERGY DERIVATIVES MARKETS 1, 9 (2013), available at <http://www.cmegroup.com/company/files/PositionLimitsWhitePaper.pdf>.

where this supposedly occurred.<sup>15</sup> The theory is that excessive speculation may result in the concentration of ownership of “open interest” in spot and more thinly-traded future delivery months which could give one or more of such dominant traders in such contract markets the ability to keep prices artificially high by outbidding other market participants whose trading might result in prices that more accurately reflect the actual supply and demand of the underlying commodity.<sup>16</sup>

By contrast, those opposed to the new limits believe there is no such thing as “excessive speculation” in futures markets because for every speculator who bets aggressively that prices are going up, there must be other speculators willing to take the opposite bet.<sup>17</sup> Thus, absent concerted activity among competing speculators, which is already illegal under United States commodity and antitrust laws,<sup>18</sup> non-collusive “excessive speculation”—however the government defines it—cannot alter the fundamental laws of supply and demand which actually dictate the price of underlying physical commodities, no matter how much “excess” speculation may take place in a given contract market.<sup>19</sup> Thus, to their way of thinking, “excessive speculation” not only cannot cause artificially inflated prices, it defies logic and common sense even to think that it might.

Furthermore, as far as history is concerned, any so-called incidents of “excessive speculation” involving concerted activity among competing speculators are already illegal and do not need position limits to police in any event because conspirators would evade them.<sup>20</sup> Alternatively, they involved actions by a single speculator whose aggressive trading, either going too long or too short, are matched by equally aggressive trading on the other side.<sup>21</sup> This is consistent with what efficient markets are supposed to do; effectively tame any artificially inflated prices which again, are determined not by speculators betting too much one way or the other, but by the rela-

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<sup>15</sup> *Position Limits for Derivatives*, *supra* note 1, at 32-34.

<sup>16</sup> *Id.* at 34.

<sup>17</sup> FIA Letter to Commodities Futures Trading Commission (Feb. 7, 2014), at 11, *available at* [http://www.futuresindustry.org/downloads/FIA\\_Position\\_Limits\\_Comment\\_Letter\\_020714.pdf](http://www.futuresindustry.org/downloads/FIA_Position_Limits_Comment_Letter_020714.pdf).

<sup>18</sup> *Id.* at attachment A.

<sup>19</sup> *Id.* at 2.

<sup>20</sup> 15 U.S.C. § 1 (“Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal.”); *see* 7 U.S.C. § 6a(a)(1).

<sup>21</sup> *See infra* note 74, p. 114 and Part IV.

tive balance of supply and demand of the underlying physical commodity.<sup>22</sup>

The CFTC's sweeping new proposal was announced on November 15, 2013 in a notice of proposed rulemaking.<sup>23</sup> Final comments on the proposal were due January 14, 2014, and the CFTC will announce its Final Decision in the coming weeks.<sup>24</sup> As this article will demonstrate, however, the legality of the CFTC's bold move in this direction is not free from doubt, and should the CFTC again stumble, efforts to impose position limits in Europe, which appears critical to the success of the United States effort, may suffer a similar fate.

### **I. CFTC RULEMAKING REFLECTS SECOND ATTEMPT TO ESTABLISH POSITION LIMITS**

This is the second time the CFTC is trying to get these position limits enacted<sup>25</sup> and it is a virtual certainty that the legality of these new rules will be challenged in legal proceedings that may eventually reach the United States Supreme Court.

The CFTC's first effort ended in failure after two trade groups, the International Swap Dealers Association and the Securities Industry and Financial Markets Association, successfully challenged the rules in federal district court in Washington.<sup>26</sup>

The heart of their challenge was that the CFTC misinterpreted its statutory authority under the CEA, as amended by Dodd-Frank.<sup>27</sup> The district court opinion, by Judge Robert L. Wilkins, an Obama appointee who was one of the president's three successful nominees to the D.C. Court of Appeals that Republican senators tried so hard last fall to block, is startling in its recitation of facts showing that not even members of the CFTC were confident that these sweeping new

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<sup>22</sup> *How Supply and Demand Determine Commodities Market Prices*, TRADINGCHARTS.COM, [http://futures.tradingcharts.com/learning/supply\\_and\\_demand.html](http://futures.tradingcharts.com/learning/supply_and_demand.html) (last visited May 2, 2014).

<sup>23</sup> *Proposed Rules*, U.S. COMMODITY FUTURES TRADING COMM'N, <http://comments.cftc.gov/FederalRegister/Proposed.aspx?Type=ListAll&Year=2013> (last visited May 2, 2014).

<sup>24</sup> *Id.*

<sup>25</sup> *Position Limits for Derivatives*, *supra* note 1, at 9-10.

<sup>26</sup> *See Int'l Swaps & Derivatives Ass'n v. United States Commodity Futures Trading Comm'n*, 887 F. Supp. 2d 259 (D.D.C. 2012).

<sup>27</sup> *Id.* at 279-80.

position limits were necessary or warranted.<sup>28</sup>

Thus, before vacating the CFTC's first attempt to impose these position limits, Judge Wilkins noted that the rules were originally adopted by the agency on October 18, 2011 by a three-to-two vote and that one of those voting in favor, along with Chairman Gary Gensler and Commissioner Bart Chilton, was Commissioner Michael V. Dunn, who admitted several months before, when the proposed rules were still pending, that "to date CFTC staff has been unable to find any reliable economic analysis to support either the contention that excessive speculation is affecting the market we regulate or that position limits will prevent excessive speculation."<sup>29</sup> The opinion further notes that "Dunn also shared his 'fear' that 'at best position limits are a cure for a disease that does not exist, or at worst it's a placebo for one that does,' " adding that "position limits may harm the very markets we're intended to protect."<sup>30</sup>

The court focused on Dunn's views because, as the deciding vote in favor of the new rules, Dunn's quandary was not unlike the court's. Thus, Dunn voted in favor of the rule not because he believed they made sense or were grounded in empirical evidence demonstrating their necessity, but because he believed Congress had required them to do it.<sup>31</sup>

Position limits are, in my opinion, a sideshow that has unnecessarily diverted human and fiscal resources away from actions to prevent another financial crisis. To be clear, no one has proven that the looming specter of excessive speculation in the futures market re-regulated even exist, let alone played any role whatsoever in the financial crisis of 2008. *Even so, Congress has tasked the CFTC with preventing excessive speculation by imposing position limits. This is the law. The law is clear and I will follow the law.*<sup>32</sup>

Even Chairman Gensler was defensive, saying that the final rule reflected the Commission's view that it was compelled to produce a certain result: "Congress did not give the Commission a

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<sup>28</sup> *Id.* at 281-82.

<sup>29</sup> *Id.* at 262.

<sup>30</sup> *Id.* at 262-63.

<sup>31</sup> *Int'l Swaps & Derivatives Ass'n*, 887 F. Supp. 2d at 264.

<sup>32</sup> *Id.* at 263-64 (emphasis added).



choice. Congress directed the Commission to impose position limits and to do so expeditiously.”<sup>33</sup>

Not surprisingly, the two dissenting commissioners, each of whom published written dissents, were less kind. Commissioner Sommers warned that the rule “would inflict the greatest harm on bona fide hedgers and ‘ironically’ may ‘result in increased food and energy costs for consumers,’ ” adding that the CFTC had “created a very complicated regulation that has the potential to irreparably harm these vital markets,” while setting the agency up “for an enormous failure.”<sup>34</sup>

For his part, Commissioner O’Malia criticized the agency’s reading of the Dodd Frank amendments to the CEA, insisting that in the context of the Act, the CFTC’s discretion is “broad enough to permit the Commission to not impose limits if they are not appropriate” and that the CFTC had “miss[ed] an opportunity to determine and define the type and extent of speculation that is likely to cause sudden, unreasonable and/or unwarranted commodity price movements so that it can respond with rules that are reasonable and appropriate.”<sup>35</sup> “O’Malia also faulted the Commission for promulgating position limits without any evidence that such limits would actually benefit the market.”<sup>36</sup>

## II. THE DISTRICT COURT’S LEGISLATIVE ANALYSIS

Faced with diametrically opposed views as to whether Congress actually mandated position limits without regard to whether the agency charged with enforcing them felt they were needed, the Court employed the Supreme Court’s two-part *Chevron* test.<sup>37</sup>

Under step one of *Chevron*, the Court first must consider

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<sup>33</sup> *Id.* at 264.

<sup>34</sup> *Id.* Under the proposed new regulations, bona fide hedgers are expected to apply for and receive hedge exemptions. However, the concern is that hedgers might not qualify for or receive in a timely manner all of the exemptions they may need which, were that to occur, would create a market in which already-issued hedge exemptions are themselves traded, with those who don’t need them selling them at a premium to those who do, with the added costs then passed on to consumers. In exchange markets where position limits and hedge exemptions are already commonplace, such trading already takes place.

<sup>35</sup> *Id.*

<sup>36</sup> *Int’l Swaps & Derivatives Ass’n*, 887 F. Supp. 2d at 264.

<sup>37</sup> See *Chevron, USA, Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 843 (1984) (testing whether congressional language directly addresses a regulatory issue, under *de novo* review, and then assessing an agency’s construction of the statute if an ambiguity is present).

whether Congress has directly spoken to the precise question at issue because, if so, the Court and the agency “must give effect to the unambiguously expressed intent of Congress.”<sup>38</sup> “Under *Chevron* Step One, the Court examines the statute *de novo*, employing traditional tools of statutory construction” to “search for the plain meaning of the statute.”<sup>39</sup>

If the statute is found to be “silent or ambiguous,” the Court moves on to *Chevron* step two and defers to the agency’s interpretation if it is based on a permissible construction of the statute.<sup>40</sup>

Here, Judge Wilkins began with Section 6a(a)(1) of the CEA, which was amended by Dodd-Frank to broaden its scope to include not just exchange-traded futures, but off-exchange swaps that “perform[] a significant price discovery function.”<sup>41</sup> Section 6a(a)(1) of the CEA has been a part of United States law in one form or another since 1936, when the idea of requiring position limits to combat “excessive speculation” in futures markets first arose.<sup>42</sup>

That provision, the court said, unambiguously requires the Commission to find that position limits are necessary prior to imposing them.<sup>43</sup> Thus, Section 6a(a)(1) states in pertinent part:

For the purpose of diminishing, eliminating, or preventing such burden [on interstate commerce caused by excessive speculation], the Commission shall, from time to time, after due notice and opportunity for hearing, by rule, regulation, or order, proclaim and fix such limits on the amounts of trading which may be done or positions which may be held by any person . . . as the Commission finds are necessary to diminish, eliminate, or prevent such burden.<sup>44</sup>

Based on this language, Judge Wilkins held that the CEA requires the CFTC to make a finding of necessity prior to imposing position limits, which it did not do, and is not doing now.<sup>45</sup> So why did

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<sup>38</sup> *Id.* at 842-43.

<sup>39</sup> *Int’l Swaps & Derivatives Ass’n*, 887 F. Supp. 2d at 268.

<sup>40</sup> *Id.* at 280.

<sup>41</sup> *Id.* at 269.

<sup>42</sup> *Id.* at 269-70.

<sup>43</sup> *Id.* at 269.

<sup>44</sup> *Int’l Swaps & Derivatives Ass’n*, 887 F. Supp. 2d at 269 (quoting 7 U.S.C. § 6a (a)(1) (2010)) (emphasis added).

<sup>45</sup> *Id.* at 270.

that not end the matter? The answer is that the CFTC and many Democrats in Congress believe other Dodd Frank amendments to the CEA effectively eliminated the necessity requirement.<sup>46</sup>

First the agency points to Section 6a(a)(2), which states that “[i]n accordance with the *standards* set forth in paragraph (1) of this subsection . . . the Commission shall by rule, regulation, or order establish limits on the amount of positions . . . .”<sup>47</sup> However, because Congress incorporated by reference the term “standards” in the immediately preceding paragraph, Judge Wilkins held that the term “standards”, which is nowhere mentioned expressly in paragraph 1, could either refer to the threshold requirement that the agency must first find position limits to be “necessary” or it could refer to some other standards.<sup>48</sup> Hence the statute was ambiguous. Because the agency didn’t bother to “interpret” the ambiguity, as required by *Chevron* part two, the Court had no choice but to issue an order vacating the rules, which it did.<sup>49</sup>

Judge Wilkins also found other ambiguities in Dodd Frank’s amendments to the CEA. Section 6a(a)(2)(A) not only directed the CFTC to establish position limits in accordance with the unspecified “standards” in subparagraph 1, which may or may not refer to the need to determine whether such limits are even necessary, but it also directed the CFTC to establish such position limits “as appropriate.”<sup>50</sup> The “as appropriate” language also appears in Section 6a(a)(3), which deals with fixing position limits in both the spot month and for all months combined, and in Section 6a(a)(5)(A), which states generally that “[n]otwithstanding any other provision of this section, the Commission shall establish limits on the amount of positions, including aggregate position limits, *as appropriate* . . . .”<sup>51</sup>

Here, too, the court found the “as appropriate” language to be ambiguous.<sup>52</sup> Thus, in the absence of any language expressly repealing the requirement from 1936 that position limits must first be premised on a finding of necessity, which Congress could easily have done but chose not to do when it passed Dodd Frank in 2010, it was un-

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<sup>46</sup> *Id.* at 263.

<sup>47</sup> *Id.* at 274 (emphasis added).

<sup>48</sup> *Id.* at 275.

<sup>49</sup> *Int’l Swaps & Derivatives Ass’n*, 887 F. Supp. 2d at 275.

<sup>50</sup> *Id.* at 278.

<sup>51</sup> *Id.* at 276 (quoting 7 U.S.C. § 6a (a)(5)(A)) (emphasis added).

<sup>52</sup> *Id.* at 276.

clear whether the language in subsequent sections mandating position limits in accordance with prior “*standards*” and “*as appropriate*” was intended to jettison the requirement for a necessity finding or whether these words were intended to mean something else.<sup>53</sup> In accordance with *Chevron* part two, in the absence of any interpretation from the agency to review, the court had no choice to but vacate.<sup>54</sup>

While the court’s ruling was pending, the CFTC announced its intention to withdraw the rules and replace them with a new proposal.<sup>55</sup> By taking that step, the CFTC effectively prevented Judge Wilkins from going any further in his ruling and determining whether the rules then under challenge were arbitrary and capricious.

However, Judge Wilkins made clear that in construing the statute, he is required to construe the statute as a whole, including the provision requiring a finding of necessity before position limits are established, and that the CFTC’s efforts to find mandatory language compelling the adoption of position limits in certain sections, without also taking into account the just-as-lawful opposite mandate in the section of the CEA dating back to 1936 which required a showing of necessity, would be unavailing.<sup>56</sup>

The court also warned the CFTC that its attempt to satisfy *Chevron* part two would be entitled to no deference if, in conducting its analysis of the apparent ambiguities in the CEA as a result of the Dodd Frank amendments, it appeared the agency continued to believe that the mandate to establish position limits without a finding of necessity was clear and unambiguous.<sup>57</sup>

Significantly, in light of the partisan political acrimony between Congressional Democrats and Republicans that followed passage of Dodd Frank, as well as the controversy surrounding Judge Wilkins’ recent Senate confirmation to serve on the appeals court,<sup>58</sup> it

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<sup>53</sup> *Id.* at 277-78.

<sup>54</sup> *Int’l Swaps & Derivatives Ass’n*, 887 F. Supp. 2d at 278.

<sup>55</sup> Michael R. Sorrell et al., *CFTC Proposes Speculative Position Limits Again*, MONDAQ (Nov. 25, 2013), <http://www.mondaq.com/unitedstates/x/276994/Commodities+Derivative+s+Stock+Exchanges/CFTC+Proposes+Speculative+Position+Limits+Again>.

<sup>56</sup> “Although the CFTC is correct that these provisions taken in isolation seemingly create a mandatory regime, the agency and this Court is required to attempt to give effect to all parts of the statute, including the ambiguous language.” *Int’l Swaps & Derivatives Ass’n*, 887 F. Supp. 2d at 279.

<sup>57</sup> *Id.* at 280-81.

<sup>58</sup> Michael R. Crittenden, *Senate Confirms Judge Wilkins to Key Federal Appeals Court*, WALL ST. J. (Jan. 13, 2014), <http://online.wsj.com/news/articles/SB10001424052702303819704579319153037797452>.

is worth noting that Judge Wilkins flatly rejected the views filed in *amici* briefs by the House Democratic Conference Committee, and by nineteen United States Senators, respectively.<sup>59</sup>

### III. THE CFTC'S NOVEMBER 15, 2013 PROPOSAL

In its proposed new rules, the CFTC spends considerable effort addressing the issues raised by Judge Wilkins. First, the agency purports to interpret the ambiguities identified by Judge Wilkins in the CEA, as amended by Dodd Frank, and not surprisingly concludes that, based on its knowledge and experience as the agency charged with enforcing position limits, Congress really did mandate off-exchange position limits without any finding of necessity.<sup>60</sup> Alternatively, in the event the court rejects the CFTC's analysis, the CFTC includes for the first time a necessity finding.<sup>61</sup>

As indicated, final comments on the CFTC's notice of proposed rulemaking were due February 10, 2014.<sup>62</sup> After reviewing the comments, the CFTC will issue its final rule, which will almost certainly be challenged, perhaps by the same parties as the last time and perhaps others.<sup>63</sup> Assuming the CFTC still insists on pushing ahead with the limits, and there is every indication that it will, it is by no means clear that the CFTC will prevail.

Specifically, the CFTC stated on November 15, 2013, "based on its experience and expertise, when [the positions limits section of the CEA] is considered as an integrated whole, it is reasonable to construe that section to mandate that the Commission impose position limits" on futures contracts, options, and certain swaps for all twenty-eight physical commodities, and "[t]he Commission also conclude[d] that the mandate requires it to impose such limits without first finding that any such limit is necessary to prevent excessive speculation in a particular market."<sup>64</sup>

However, nowhere in its analysis did the CFTC really do what Judge Wilkins had asked, which was to square on one hand the

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<sup>59</sup> *Int'l Swaps & Derivatives Ass'n*, 887 F. Supp. 2d at 282-83.

<sup>60</sup> *See generally Position Limits for Derivatives*, *supra* note 1, at 9-13.

<sup>61</sup> *Id.* at 21-22.

<sup>62</sup> U.S. COMMODITY FUTURES TRADING COMM'N, <http://comments.cftc.gov/FederalRegister/Proposed.aspx?Type=ListAll&Year=2013> (last visited May 2, 2014).

<sup>63</sup> *Position Limits for Derivatives*, *supra* note 1, at 93, 113-14.

<sup>64</sup> *Id.* at 9.

clear and unambiguous mandate in the CEA, dating back to 1936 requiring the CFTC to determine that position limits in specific contract markets are actually needed before ordering them, with the more ambiguous Dodd Frank language added to the CEA requiring that the CFTC impose position limits in accordance with certain unspecified “standards” that must be met before position limits may be imposed, and the further ambiguous requirement in several subsections that such new position limits be imposed “as necessary.”<sup>65</sup>

Instead, the CFTC concluded that because the Dodd Frank amendments called for new position limits to be implemented relatively quickly, *i.e.*, within 180 days from enactment of Dodd Frank for metals and energy and within 270 days from enactment for agricultural products, Congress “did not intend for the Commission to make a necessity finding as a prerequisite to the imposition of limits” because there wouldn’t be enough time to make the required findings in each of the twenty-eight physical commodities covered.<sup>66</sup>

Besides, the CFTC said, Congress did its own studies.<sup>67</sup> Here, the CFTC cited work done several years before by staff members working for the Senate Permanent Subcommittee on Investigations.<sup>68</sup> These reports, the CFTC said, “concluded that excessive speculation accounted for significant volatility and price increases in physical commodity markets.”<sup>69</sup>

In fact, there were only two such investigations. The first, conducted in 2006, dealt with increases in the price of crude oil, in which subcommittee staff found evidence suggesting that speculation was responsible for an increase of as much as \$20-25 per barrel of crude oil, which was then at \$70.<sup>70</sup> The theory was that speculators were driving up the price of crude oil for future delivery and that oil

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<sup>65</sup> *Id.* at 11.

<sup>66</sup> *Id.* at 10-11.

<sup>67</sup> *Id.* at 11-12.

<sup>68</sup> *Position Limits for Derivatives*, *supra* note 1, at 12 nn.23-25. In his opening remarks on November 5, 2013, the day the CFTC approved the “revised” form of position limits, Chairman Gensler praised the work done for the agency by its former general counsel, Dan Berkovitz. Prior to joining the CFTC as general counsel, Mr. Berkovitz worked for the Senate Permanent Subcommittee on Investigations where he was responsible for the work staff members did on excessive speculation. *Id.* at 522-23.

<sup>69</sup> *Id.* at 11.

<sup>70</sup> PERMANENT SUBCOMM. ON INVESTIGATIONS, THE ROLE OF MARKET SPECULATION IN RISING OIL & GAS PRICES: A NEED TO PUT THE COP BACK ON THE BEAT, S. REP. NO. 109-65, at 2 (2006), available at <http://www.gpo.gov/fdsys/pkg/CPRT-109SPRT28640/pdf/CPRT-109SPRT28640.pdf>.

producers, in an effort to cash in on the speculative bonanza for them in the futures market, hoarded their oil so as to create an artificial shortage and take advantage of the higher prices.<sup>71</sup>

There are several problems with this analysis. First, it assumes that all competing oil producers act like the oil cartel OPEC. But, there is in fact no evidence that competing oil producing companies are members of a cartel and would, as cartel members, willingly withhold oil from the market and forego immediate profits in the hope of getting even higher profits down the road. However, absent such collusion among competing oil producing companies, which would be illegal, it would be very difficult and expensive for individual competitors to withhold oil or oil products from the market in the hope of driving up the price.<sup>72</sup> Even if they wanted to withhold their product from the market, the ability of oil producers to store crude oil once removed from the ground is limited. Oil, once pumped out of the ground, is generally transported to oil refineries around the world. Thus, assuming no actual change in physical supply or demand, any increase in the price of oil attributable to “excess speculation” in the futures markets would appear to be short lived. Indeed, absent any perceptible change in anticipated supply or demand, speculators who bid up the price of oil would be met with speculators convinced there is no basis for such higher prices who would just as quickly bid the price down.

The problem, of course, is that not everyone may agree on the future course of physical supply and demand. Thus, increases in the price of crude oil during the period of time that subcommittee staff was examining could just as easily be attributable not so much to “excess speculation,” however that term is defined, but to anticipated

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<sup>71</sup> *Id.*

<sup>72</sup> The NYMEX futures contract for gasoline (reformulated gasoline) calls for delivery to New York Harbor. The contract is based on barrels, and there are 42,000 gallons to a barrel. If a speculator wanted to hoard gasoline for the purpose of driving up its price, i.e., squeeze the market, it would first have to buy up nearby long positions in such gasoline; then, rather than cash settle such positions, it would take physical delivery of the product in New York and, rather than sell it in the ordinary course or otherwise make it available to short sellers to cover their positions, the speculator could thereby effectively squeeze the market. The problem is that New York Harbor can store as much as seventy-five million barrels of gasoline. To corner the market would require acquiring a substantial amount of such storage. At \$3 per gallon of gasoline, the cost to engineer a squeeze in New York Harbor would be astronomical, (e.g., 42,000 x \$2 x 50,000,000 barrels) before adding in the costs of storage and insurance. In any event, the exercise is largely academic because NYMEX has long had position limits of its own on energy products.

increases in demand for oil from China, whose economy during the period studied was experiencing unprecedented growth.<sup>73</sup> Obviously, if the market guesses wrong about a major factor such as Chinese demand, prices will experience volatility, but there is nothing in the CFTC discussion that explains how subcommittee staffers were able to conclude the crude oil market would move substantially up or down because of “excess speculation” or because of new information, which may bear on the future direction of prices.

The second Congressional study cited by the CFTC, as proof of Congressional intent that no finding of necessity to combat “excess speculation” was needed, was a report by the same Congressional subcommittee in 2007 concerning natural gas.<sup>74</sup> All the CFTC says about that study is that “Congress found similar price volatility stemming from excess speculation in the natural gas market.”<sup>75</sup> In fact, the natural gas report dealt largely with a single hedge fund that, in the summer of 2006, purchased an unusually large number of natural gas futures contracts for winter delivery, and in so doing, bid up the price.<sup>76</sup> However, because traders saw no fundamental change in expected supply or demand for natural gas, other hedge funds quickly realized that prices for such delivery were too high.<sup>77</sup> Accordingly, they began to sell short, thus bidding the price for winter delivery down.<sup>78</sup> As a result, when prices declined, the company that bet prices would rise had to pay margin calls, and because the volume of their positions was so large, the margins calls effectively forced the fund out of business.<sup>79</sup> In the meantime, prices returned fairly quickly to where the market believed they should have been in the first place.<sup>80</sup>

Nevertheless, based on these two subcommittee reports, the CFTC said Congress “had already gathered evidence regarding the impact of excessive speculation, and had concluded that such speculation imposed an undue burden on the economy[,]” and that “[i]n

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<sup>73</sup> S. REP. NO. 109-65, at 10 (2006).

<sup>74</sup> PERMANENT SUBCOMM. ON INVESTIGATIONS, EXCESSIVE SPECULATION IN THE NATURAL GAS MARKET. (2007), available at <https://www.levin.senate.gov/imo/media/doc/supporting/2007/PSI.Amaranth.062507.pdf>.

<sup>75</sup> *Position Limits for Derivatives*, *supra* note 1, at 12.

<sup>76</sup> EXCESSIVE SPECULATION IN THE NATURAL GAS MARKET, *supra* note 74, at 51-52.

<sup>77</sup> *Id.* at 53.

<sup>78</sup> *Id.*

<sup>79</sup> *Id.*

<sup>80</sup> *Id.*



light of these investigations and conclusions, it is reasonable for the Commission to conclude that Congress did not intend for it to duplicate investigations Congress had already conducted, and did not intend to leave it up to the Commission whether there should be federal limits.”<sup>81</sup>

In short, based on these two Congressional staff reports, the CFTC has concluded that, based on its own experience, it is reasonable to interpret the Dodd Frank amendments to the CEA as not only mandating speculative position limits in privately negotiated swaps involving twenty-eight different physical commodities, but impliedly also reading out of the CEA entirely the otherwise unambiguous requirement, dating back to 1936, that any federally imposed position limit must be preceded by an agency finding that “such limit is necessary to prevent excessive speculation in a particular market.”<sup>82</sup>

In addition to the Congressional staff reports, the CFTC also said it was relying on a 1981 CFTC rule that required United States futures markets to adopt “speculative position limits for ‘for each separate [futures] contract for which delivery months are listed to trade.’”<sup>83</sup> The 1981 rule specified the criteria for determining how the required limits would be set, but did not include the antecedent judgment of whether to order limits at all.<sup>84</sup> In short, the CFTC ordered speculative position limits to be established for all United States exchanged traded futures – but it did so without any showing of excessive speculation or other burdens on the market.<sup>85</sup> Thus, the CFTC’s argument here is that because it dispensed with the 1981 statutory prerequisite for imposing position limits, and no one at the time challenged the CFTC’s having done so, it is just as reasonable for the CFTC to dispense with the same statutory prerequisite in expanding the scope of its authority to cover all privately negotiated swaps that effectively function like exchange-traded futures.<sup>86</sup>

Finally, the CFTC concludes that Congress impliedly dispensed with the statutory prerequisite for making contract-by-contract findings because one of the Dodd Frank amendments requires the CFTC to conduct a study of the effects, if any, of the limits

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<sup>81</sup> *Position Limits for Derivatives*, *supra* note 1, at 12.

<sup>82</sup> *Id.* at 9.

<sup>83</sup> *Id.* at 15.

<sup>84</sup> *Id.* at 15-16.

<sup>85</sup> *Id.* at 17.

<sup>86</sup> *Position Limits for Derivatives*, *supra* note 1, at 15-16.

it establishes – once the limits have been in effect.<sup>87</sup> Here, the CFTC argues that Congress would not have required them to conduct a second study if it wasn't dispensing altogether with the statutory mandate requiring a study before any position limits are imposed.<sup>88</sup>

Of course, the CFTC's argument still leaves open the question of why, if Congress was dispensing with an unambiguous statutorily-mandated finding of necessity dating back to the 1930s, it didn't come right out in Dodd Frank and say so. Here, the CFTC argues that because the Dodd Frank position limits apply only to physical commodities (and thus exempt such things as interest rate and currency futures, which are always cash-settled and thus never settled by physical delivery), the statutory necessity findings are still applicable here – in that narrow context.<sup>89</sup> Hence, the CFTC argues, there was no need for Congress to repeal the need for a necessity finding.<sup>90</sup>

However, the CFTC did not point to any language in Dodd Frank's legislative history to suggest that Congress was intending to do any such thing. That brings us back to the CFTC's overall experience as the agency charged with enforcement of the anti-manipulation provisions of the CEA. However, the CFTC cites nothing in its experience enforcing the CEA that would support any finding that Congress wanted to preserve the legislative prerequisite of a finding of "need" before imposing position limits for off-exchange futures contracts that did not require physical delivery.

Thus, if "excessive speculation" could drive up interest rates and foreign currency just as easily as it could drive up the price of physical commodities, why then would Congress dispense with a finding of necessity for futures trading involving physical commodities, and not dispense with such a finding for such things as interest rates and foreign currency? Absent any experience by which the CFTC could draw a conclusion one way or the other, it would appear that the CFTC's rationale may be deemed sufficiently arbitrary so as not to pass legal muster.

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<sup>87</sup> *Id.* at 18-19.

<sup>88</sup> *Id.* at 19.

<sup>89</sup> *Id.* at 19-20.

<sup>90</sup> *Id.* at 19-21.

#### IV. AS A FALL BACK, THE CFTC MAKES A “NECESSITY” FINDING

Given the apparent weakness of its position, it is not surprising that the CFTC has also embraced a fallback position, i.e., it goes on to say in its proposed new regulations, that even if a necessity finding is required, “out of an abundance of caution in light of the district court decision,” it is now making one.<sup>91</sup> However, the CFTC’s finding on that score may be just as weak as its statutory interpretation.

As indicated above, since 1936, the CEA (or its predecessor) has required that before speculative position limits may be imposed, there must first be a “finding that such limits are necessary ‘to diminish, eliminate or prevent excessive speculation causing sudden or unreasonable fluctuations or unwarranted changes in the prices of’ commodities.”<sup>92</sup>

Here, the Commission asserts that speculative position limits are “necessary as a prophylactic measure” for two reasons.<sup>93</sup> First, “to lessen the likelihood that a trader will accumulate excessively large speculative positions that can result in corners, squeezes, or other forms of manipulation that cause unwarranted or unreasonable price fluctuations.”<sup>94</sup> And second, they are also necessary *because “even if not accompanied by manipulative conduct”* “excessively large speculative positions may cause sudden or unreasonable price fluctuations.”<sup>95</sup>

To support the first prong of its findings, the CFTC cites the 1979-80 cornering of the silver market by the Hunt Brothers.<sup>96</sup> The story is not new or novel. The Hunts conspired to corner the silver market by buying up long silver positions, taking delivery on those positions and, by creating an actual shortage of physical silver in the market, forcing short sellers of silver to pay artificially high prices to close out their positions.<sup>97</sup>

In other words, the Hunt Brothers and their co-conspirators did not just speculate excessively in the futures market, they altered

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<sup>91</sup> *Position Limits for Derivatives*, *supra* note 1, at 21-22.

<sup>92</sup> *Id.*

<sup>93</sup> *Id.* at 22.

<sup>94</sup> *Id.*

<sup>95</sup> *Id.* (emphasis added).

<sup>96</sup> *Position Limits for Derivatives*, *supra* note 1, at 23.

<sup>97</sup> *Id.* at 23-24.

the fundamental rules of physical supply and demand of the underlying physical commodity by hoarding silver that would otherwise have been available to short sellers and industrial users, thus forcing up prices artificially.<sup>98</sup> When the government figured out what the Hunts and their co-conspirators were doing, position limits were imposed, thus forcing the Hunts to give up the squeeze, which caused prices to plummet.<sup>99</sup>

There is no question that the Hunt Brothers and their co-conspirators engaged in a conspiracy to artificially inflate the price of silver. Their conduct was found to be a violation of not just the anti-manipulation provisions of the Commodity Exchange Act, but the United States antitrust laws, i.e., Section 1 of the Sherman Act.<sup>100</sup>

But nowhere does the Commission demonstrate how position limits, had they been in effect in 1979 and 1980, would have worked to prevent the conspiracy. The existence of position limits might have made it harder to manipulate the price of silver, but no one can demonstrate that the conspiracy would not have occurred. At the heart of the Hunt conspiracy, as well as just about every other conspiracy, is secrecy. What made the Hunt conspiracy work was the fact that the Hunts had secretly lined up confederates that they knew would join with them in buying up long silver positions, taking physical delivery, and squeezing the shorts.<sup>101</sup>

Thus, had position limits been in effect, the conspirators would have simply evaded them, just as they tried to evade the CEA and the United States antitrust laws.<sup>102</sup> The CFTC thus makes no demonstration in its sixteen pages of discussion that had position limits been in effect, no such conspiracy would have been possible.

Instead, the CFTC quotes a report prepared by the “staffs” of the CFTC, the Board of Governors of the Federal Reserve System, the Department of the Treasury, and the Securities and Exchange Commission that “reasonable speculative position limits, [had they] been in place before the buildup of large positions occurred, would have helped prevent the accumulation of such large positions and the resultant dislocations created when the holders of those positions

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<sup>98</sup> *Id.* at 25-26.

<sup>99</sup> *Id.* at 26.

<sup>100</sup> *See Minpeco, S.A. v. Hunt*, 718 F. Supp. 168, 170 (S.D.N.Y. 1989).

<sup>101</sup> *Position Limits for Derivatives*, *supra* note 1, at 25.

<sup>102</sup> *Minpeco*, 718 F. Supp. at 170.

stood for delivery.”<sup>103</sup> That is, according to the CFTC “speculative position limits would have helped to prevent the buildup of the silver price spike of 1979-80.”<sup>104</sup>

To support that conclusion, the CFTC points to the fact that by late 1979, when the Chicago Board of Trade imposed position limits and raised margin requirements, long positions had to be liquidated, which resulted, not surprisingly, in the short squeeze abruptly coming to an end.<sup>105</sup>

But what the CFTC nowhere tries to show is how, in the teeth of a secret conspiracy to fix prices, the existence of speculative position limits would somehow act as a deterrent. Instead, the Commission states, “if Federal speculative position limits had been in effect that correspond to the limits that the Commission proposes now, across markets now subject to Commission jurisdiction, such limits would have prevented the Hunt brothers and their cohorts from accumulating such large futures positions.”<sup>106</sup> In short, the CFTC relies on its own *ipse dixit*.

The CFTC then argues that position limits are still needed as a prophylactic to prevent “excessive speculation,” *even in the absence of manipulative behavior*.<sup>107</sup> Here, the Commission relies in part on a staff report prepared by the Senate Permanent Subcommittee on Investigation,<sup>108</sup> which in 2007 looked into the behavior of Amaranth Advisors LLC, the hedge fund that collapsed in September 2006 after building up that summer an unusually large long position in natural gas futures for delivery that winter,<sup>109</sup> a CFTC enforcement action against Amaranth,<sup>110</sup> and a still pending enforcement action against Amaranth’s former head energy trader.<sup>111</sup>

Unlike the Hunt Brothers, Amaranth did not conspire with anyone; nor did it take physical delivery of any physical commodity in an attempt to engineer a corner or a short squeeze. Indeed, Amaranth did not engage in any manipulative behavior at all.

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<sup>103</sup> *Position Limits for Derivatives*, *supra* note 1, at 24.

<sup>104</sup> *Id.*

<sup>105</sup> *Id.* at 26.

<sup>106</sup> *Id.* at 35.

<sup>107</sup> *Id.* at 22.

<sup>108</sup> *See generally* EXCESSIVE SPECULATION IN THE NATURAL GAS MARKET, *supra* note 74.

<sup>109</sup> ACTIVITIES OF THE COMM. ON HOMELAND SEC. & GOV’T AFFAIRS, S. REP. NO. 111-360, at 143 (2010).

<sup>110</sup> *Id.* at 145.

<sup>111</sup> *Id.*

Instead, Amaranth, which could neither make nor take delivery of physical natural gas, made a very large bet in the summer of 2006 that the spread between natural gas prices for delivery that winter and summer would be far greater than usual.<sup>112</sup>

Amaranth engaged in spread trading. Spread trading is a trading strategy often employed in commodities where prices vary seasonally.<sup>113</sup> A spread trader bets not so much on the absolute price of the commodity going up in winter – everyone expects that it will go up in winter and down in summer – but rather on the amount of the actual spread between the prices in different months. Thus, Amaranth would sell short natural gas in delivery months where it believed prices would actually go lower and at the same time it would go long in delivery months where it believed prices would actually go higher. If it guessed right in both legs of the trade, it would have a substantial gain.

Amaranth's bet in 2006 was quite large.

During the spring and summer of 2006, Amaranth controlled between 25 and 48% of the outstanding contracts . . . in all NYMEX natural gas futures contracts for 2006; about 30% of the outstanding contracts . . . in all NYMEX natural gas futures contracts for 2007; between 25 and 40% of the outstanding contracts . . . in all NYMEX natural gas futures controls for 2008; between 20 and 40% of the outstanding contracts . . . in all NYMEX natural gas futures contracts for 2009; and about 60% of the outstanding contracts . . . in all NYMEX natural gas futures contracts for 2010.<sup>114</sup>

The senate subcommittee staff found that Amaranth's large positions resulted in "significant price movements in key natural gas futures prices and price relationships" and that they were a "predominant cause" of an increasing price spread between summer and winter contracts.<sup>115</sup> In other words, the committee concluded that the huge concentration of ownership of open interest in natural gas futures contracts by Amaranth was itself the cause of prices being artificially

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<sup>112</sup> *Id.* at 167.

<sup>113</sup> Adam Milton, *Spread Trading*, ABOUT.COM (last visited May 2, 2014), <http://daytrading.about.com/od/stou/g/SpreadTrading.htm>.

<sup>114</sup> *Position Limits for Derivatives*, *supra* note 1, at 41 n.107.

<sup>115</sup> S. REP. NO. 111-360, at 167 (2010).

inflated.<sup>116</sup>

The CFTC then cited the senate subcommittee's conclusion that "purchasers of natural gas during the summer of 2006 for delivery in the following winter months paid inflated prices due to Amaranth's speculative trading," and that "many of these inflated costs were passed on to consumers, including residential users who paid higher home heating bills[, and that s]uch inflated costs [we]re clearly a burden on interstate commerce."<sup>117</sup>

However, if Amaranth's trading single-handedly caused natural gas futures prices for winter delivery to rise artificially, i.e., to a level not warranted by anticipated physical supply and demand, then it stands to reason that other traders in the market would see this as an opportunity to sell short an overpriced asset, and thereby quickly force these prices down to where they should be, with no one other than Amaranth getting hurt, which appears to be exactly what happened.

Neither the senate subcommittee staffers nor the CFTC seem to allow for this possibility. The subcommittee report states:

Amaranth had held as many as 100,000 natural gas contracts in a single month, representing . . . 5 percent of the natural gas used in the entire United States in a year. At times Amaranth controlled 40 percent of all of the outstanding contracts in the NYMEX exchange for natural gas in the winter season (October 2006 through March 2007), including as much as 75 percent of the outstanding contracts to deliver natural gas in November 2006.<sup>118</sup>

The implication is that excessive amounts of futures contracts were to blame.

However, there was plenty of evidence that Amaranth had simply made the wrong bet. Like all commodities, the price of natural gas depends on relative supply and demand. Heading into the winter season, traders look to see how much natural gas is in storage and whether the forecast that winter is for a cold or a mild winter. If the amount of gas in storage is greater than expected, and the winter is predicted to be mild then prices will tend to come down because of

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<sup>116</sup> *Id.*

<sup>117</sup> *Position Limits for Derivatives*, *supra* note 1, at 42.

<sup>118</sup> S. Rep. No. 111-360, at 167 (2010).

the expectation that supplies for the coming winter will be abundant.

On the other hand, because most natural gas stored in the United States is in facilities that are prone to destruction in the event of a hurricane,<sup>119</sup> the possibility of one or more bad hurricanes, combined with a winter predicted to be colder than normal, would tend to force prices up.

Here, Amaranth, made a large bet that natural gas prices would rise, and the market evidence in September 2006, when Amaranth reportedly lost \$6 billion on its natural gas positions, was that there was not only ample storage, but that forecasters were expecting both a mild hurricane season and a mild winter as well. Not surprisingly, hedge funds seeing that same data would conclude that natural gas prices for delivery that winter were too high and would look to enter into short positions. Because these positions are traded on the NYMEX, no one has to target Amaranth as such, although it was probably the case that most savvy traders knew Amaranth was responsible for driving up the prices and that such increases were not supported by market fundamentals. But it did not take much to drive the prices back down and it was the resulting margin calls necessitated by a drop in price that caused Amaranth's collapse.

So, what then to make of the CFTC's conclusion that Amaranth's excessive speculation in the summer of 2006 caused purchasers of natural gas to pay more for delivered natural gas that winter? There is certainly no evidence of that cited in the CFTC's Notice of Proposed Rulemaking. And it is hard to believe there would be much evidence of that. If the reports that summer had anticipated an ample supply of natural gas in storage, and the forecasts for the hurricane and winter seasons were both expected to be mild, it is difficult to believe that anyone would have had to pay more than they should have for delivery of natural gas that winter. And if they did not have to pay more than they should have, there is no evidence that any artificially inflated costs were passed on to their customers. Here, too, the CFTC cites none in its notice; nor do they cite to any such data on the senate staff report.

That is not to say that there could not have been any such evidence. But the CFTC notice makes no mention of the price-discovery effect of arbitrage, which is the process by which traders

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<sup>119</sup> Simon Romero, *Natural Gas: Big Worry This Winter*, N.Y. TIMES (Nov. 15, 2005), [http://www.nytimes.com/2005/11/15/business/15natgas.html?pagewanted=all&\\_r=0](http://www.nytimes.com/2005/11/15/business/15natgas.html?pagewanted=all&_r=0).



seek price discrepancies for equivalent goods in different markets.<sup>120</sup> Given advances in technology, traders today can quickly detect whether future pricing for natural gas, or any other physical commodity, is too high or too low by comparing pricing for similar products. Thus, for example, a natural gas trader would look at pricing for natural gas in other parts of the world, as well as prices for comparable products in the United States, such as heating oil, to identify pricing discrepancies and opportunities to profit through arbitrage. And because of the computerized sophistication by which such trading takes place today, it is difficult to imagine pricing anomalies like those created by Amaranth lasting very long. Indeed, because Amaranth's bet was so extraordinarily large and risky, it only took about a month or two before natural gas prices fell enough by September 2006 that Amaranth itself collapsed, losing \$6 billion.<sup>121</sup>

Perhaps the best example of the dubious nature of the CFTC's theory of "excessive speculation" causing prices to rise is explained by what happened to the German firm Metallgesellschaft ("MG").<sup>122</sup> In the fall of 1993, MG's United States affiliate purchased near term long positions in heating oil on the NYMEX and in over-the-counter swaps equal to forty-three times the daily production of Kuwait.<sup>123</sup> No one before had ever amassed a speculative long position that large.<sup>124</sup>

But MG's speculative oil trading, as massive as it was, did not move oil prices higher. This is because MG's massive long position did not fundamentally alter actual physical supply or demand. However, on Thanksgiving 1993, when OPEC oil ministers were unable

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<sup>120</sup> Hiren M. Maniar, *Price Discovery and Arbitrage Between Futures and Cash Markets—A Case Study on National Stock Exchange of India (NSE)*, 24 FIN. INDIA 929 (2010), available at [http://www.larsentoubro.com/lntcorporate/pmiv/pdf/Journal\\_Paper\\_1.pdf](http://www.larsentoubro.com/lntcorporate/pmiv/pdf/Journal_Paper_1.pdf).

<sup>121</sup> S. REP. NO. 111-360, at 166 (2010).

<sup>122</sup> GEOFFREY POITRAS, RISK MANAGEMENT, SPECULATION, AND DERIVATIVE SECURITIES 58-60 (2002).

<sup>123</sup> *Id.* at 58-59.

<sup>124</sup> *Id.* at 58. Ironically, MG took the position that its huge near-term long position was actually a bona fide hedge because it had entered into a series of ten-year fixed price contracts for the sale of heating oil and gasoline. However, most of those contracts did not call for the actual delivery of any oil products until the end of the ten-year term, and if at any time during that ten-year period the market price of such products exceeded the fixed price in the contracts, the customer could cancel the entire contract and receive a cash payment equal to the difference between the spike price and the fixed price times the total amount of product not delivered. Because MG gave away these contracts for free, they were widely criticized as mere excuses to speculate, resulting in the largest speculative oil futures position in history.

to agree on a quota to restrict production, which obviously did have an impact on anticipated supplies, near term oil prices fell by about a \$4 a barrel, from about \$19 to \$15 – which was enough to cause MG to suffer margin calls it could not afford to meet.<sup>125</sup>

Nevertheless, it is theoretically possible that in certain markets there might be price stickiness where, because “excessive speculation” has inflated a price, other related pricing remains stuck at artificially high levels notwithstanding the existence of arbitrage. It is also possible that absent manipulation and position limits, speculators competing with one another could themselves create a feeding frenzy, creating commodity bubbles where the rules of physical supply and demand say they should not exist, and thus creating market volatility which itself can be a problem.

That would presumably be the kind of investigation and finding on a market-by-market basis that the original provisions of the CEA intended the CFTC to make. However, the CFTC, in its latest notice of proposed rulemaking, cites the senate subcommittee’s report on Amaranth as proof that Congress intended to eliminate that requirement, which may be difficult for the CFTC to sustain in court.<sup>126</sup>

And even though the CFTC does not address it, there is a well-recognized circumstance where aggressive trading by a single trader, acting alone, can in fact move markets higher.<sup>127</sup> This occurs when a trader acquires a dominant position in the futures market by controlling at least 50% or more of both the commodity’s near term long positions and the actual physical commodity available for immediate delivery.<sup>128</sup>

The actual physical commodity available for immediate delivery is a term of art that refers to specific lots of the commodity stored in exchange warehouses.<sup>129</sup> Under the terms of every futures contract traded in the world, the owner has the right, but not the obli-

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<sup>125</sup> POITRAS, *supra* note 122, at 60.

<sup>126</sup> *Position Limits for Derivatives*, *supra* note 1, at 43.

<sup>127</sup> Tatyana Shumsky, *At London Metal Exchange, Mystery Buyer Holds Bulk of LME Copper*, WALL ST. J. (Dec. 2, 2010), <http://online.wsj.com/news/articles/SB10001424052748703865004575648934244174898>.

<sup>128</sup> JERRY W. MARKHAM, LAW ENFORCEMENT AND THE HISTORY OF FINANCIAL MARKET MANIPULATION 5 (2014).

<sup>129</sup> *CFTC Glossary*, U.S. COMMODITY FUTURES TRADING COMMISSION, <http://www.cftc.gov/consumerprotection/educationcenter/cftcglossary/index.htm> (last visited May 2, 2014).

gation, to make or take delivery of that commodity.<sup>130</sup> Most transactions, however, are cash settled, which means that the holder of a long position will settle up his trade with the holder of a short position.<sup>131</sup>

Short sellers are traders holding contracts to deliver a commodity at a fixed price in the future, having previously “sold” the commodity.<sup>132</sup> As the contract matures, the short seller must either match his trade with that of a long seller, and cash settle the difference in price or the short seller can purchase the physical commodity from someone holding the commodity in an exchange warehouse.<sup>133</sup>

Normally, there is no problem. But when an aggressive trader does what the Hunt Brothers did, i.e. buys a large number of long positions, and when contracts mature, rather than cash settling, instead takes physical delivery of the commodity. And, then continues buying long positions but this time refuses to make the physical commodity available to short sellers, the market is being squeezed.

When short sellers are squeezed in this fashion, the dominant trader is able to extract an artificially high price to close out his long trades.<sup>134</sup> There is no question that such speculative trading, if allowed to continue, will drive up prices artificially and thereby force consumers to pay higher prices.<sup>135</sup>

But are mandatory position limits the answer?

When a trader singlehandedly uses his market power over both near-dated long futures positions and ownership of the physical commodity to demand supra-competitive prices from short sellers, such conduct violates both the anti-manipulation provisions of the CEA and Section 2 of the Sherman Act’s provisions.<sup>136</sup>

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<sup>130</sup> See generally Elizabeth D. Lauzon, Annotation, *What are “Contracts of Sale of a Commodity for Future Delivery” Within Meaning of Commodity Exchange Act (7 U.S.C.A. §§ 1 et seq.)*, 182 A.L.R. FED. 559 (2002).

<sup>131</sup> *How Futures Work*, NYSE Euronext, <https://nyse.nyx.com/education/all-about-investing/futures/how-futures-work> (last visited May 2, 2014).

<sup>132</sup> Reem Heikal, *Futures Fundamentals: How The Market Works*, INVESTOPEDIA, <http://www.investopedia.com/university/futures/futures2.asp> (last visited May 2, 2014).

<sup>133</sup> William O. Fisher, *Does the Efficient Market Theory Help Us Do Justice in A Time of Madness?*, 54 EMORY L.J. 843, 917-19 (2005).

<sup>134</sup> Kevin A. Crisp, *Giving Investors Short Shrift: How Short Sale Constraints Decrease Market Efficiency and A Modest Proposal for Letting More Shorts Go Naked*, 8 J. BUS. & SEC. L. 135, 151 (2008).

<sup>135</sup> Bill Zielinski, *Understanding How a Short Squeeze Can Cause a Stock to Soar*, ANSWERS, <http://investing.answers.com/investing-101/understanding-how-a-short-squeeze-can-cause-a-stock-to-soar> (last visited May 2, 2014).

<sup>136</sup> Vandenberg & Feliu LLP, *Comments of Vandenberg & Feliu LLP on Proposed Rule*

In other words, there is already a remedy for this situation. What is more, the CFTC already has the ability to monitor those holding large long positions in particular commodities as well as those owning physical commodities stored in exchange warehouses and can, if doing its job, bring legal action to enjoin traders seeking to squeeze the market.

## V. THE LME'S ALTERNATIVE TO POSITION LIMITS

If the CFTC believes that there is not enough regulatory oversight, it might wish to take a look at what the London Metal Exchange (LME) does.

The LME has no position limits, but it employs what is called “lending guidance” to prevent dominant traders from using their market power to extract “supra competitive” prices from short sellers.<sup>137</sup> Under the LME’s regulatory regime, lending guidance is triggered whenever a trader holds 50% or more of a near term long position and ownership of stocks in the warehouse.<sup>138</sup> Such traders, in such circumstances, are required to “lend” their physical stocks to short sellers at a fraction of the prevailing premium.<sup>139</sup> The fraction decreases as the percentage ownership increases to the point where once the 90% threshold is reached, the trader must “lend” his physical stocks to short sellers without receiving any premium at all.<sup>140</sup>

In other words, the LME’s guidelines are intended to gradually eliminate any market power a dominant trader may hope to acquire.

The LME’s lending guidelines were developed only about ten years ago.<sup>141</sup> Prior to their adoption, the LME would look at pricing on its markets and impose limits whenever it thought there might be

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*change To List and Trade Shares of the JPM XF Physical Copper Trust Pursuant to NYSE Arca Equities Rule 8.201*, at 8 (May 9, 2012), <http://www.sec.gov/comments/sr-nysearca-2012-28/nysearca201228-1.pdf>.

<sup>137</sup> Thorsten Schier, *LME chief says lending rules robust enough to prevent disruption*, AMM (Nov. 4, 2010, 12:18 PM), <http://www.amm.com/Article/2724920/LME-chief-says-lending-rules-robust-enough-to-prevent-disruption.html>.

<sup>138</sup> Diarmuid O’Hegarty, *Lending Guidance for LME Metals*, LONDON METAL EXCHANGE 4 (Dec. 15, 2005), [http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/metalmarkets032510\\_ohegarty2.pdf](http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/metalmarkets032510_ohegarty2.pdf).

<sup>139</sup> *Id.*

<sup>140</sup> *Id.*

<sup>141</sup> *Id.* at 1.

abuses taking place.<sup>142</sup>

Specifically, the LME would monitor levels of backwardation. Backwardation is what occurs when the near term prices for future delivery of a commodity exceed the prices for delivery of that same commodity later in time.<sup>143</sup> When a market is being squeezed, near term prices can rise dramatically, thus increasing the backwardation.<sup>144</sup>

The LME's response, when that occurred, was to impose arbitrary limits on the level of backwardation.<sup>145</sup>

The problem with that arbitrary approach, however, was that not all backwardation results from squeezes. Thus, backwardation can occur when there is a temporary disruption in supply, thus causing prices for immediate delivery of a commodity to spike. When that occurs, holders of long positions stand to profit, of course, but such profit-making is not only legitimate, but the near-term higher prices will, at least in theory, encourage producers to make more of the commodity in order to satisfy the near-term demand. The result is that supply and demand will eventually be back in balance. The problem with the LME's approach was that arbitrarily limiting the backwardation, absent proof of a squeeze, could undermine the normal forces of supply and demand that would incentivize production of more supply.

Hence, the LME came up with the idea of its lending guidelines.<sup>146</sup>

The LME has made clear that it believes its lending guidelines offer a much better approach than position limits.<sup>147</sup> However, the

<sup>142</sup> WIKIPEDIANS, DERIVATIVES 153.

<sup>143</sup> *Id.*

<sup>144</sup> *Backwardation*, INVESTOPEDIA, <http://www.investopedia.com/terms/b/backwardation.asp> (last visited May 2, 2014).

<sup>145</sup> O'Hegarty, *supra* note 138, at 2.

<sup>146</sup> *Id.* at 1.

<sup>147</sup> *Id.* at 2. The LME's lending guidance is not without its own flaws, though. Thus, for example, as LME warehouse stocks decline, the LME becomes more and more vulnerable to a squeeze, as it takes much less metal to squeeze the market. Furthermore, not all metal capable of immediate delivery to satisfy a short position, and thus avoid a squeeze, may be found in LME warehouses, which tend to charge substantially higher rental storage costs than non-LME warehouses. If LME-grade metal is stored in lower cost non-LME warehouses, e.g., at a smelter's storage facilities, such metal may be used to squeeze the market and, because such metal outside of LME warehouses is not counted in determining LME lending guidance, traders who accumulate such metal in these locations can, at least in theory, successfully squeeze the market. The only practical limit at present on such conduct is the cost.

LME is not about to criticize the CFTC for insisting instead on position limits.

One reason may be that the LME competes with United States exchanges in the sale of metals and the prospect of mandatory position limits for United States exchanges may put the United States exchanges at a competitive disadvantage.

The reason is that once the United States mandates position limits for speculators, the United States must simultaneously get into the business of regulating exemptions from such limits for so-called bona fide hedgers.

In the old days, hedgers were anyone actually engaged in the physical commodity business that was seeking to shift a price risk. All a hedger had to do to show that it was entitled to an exemption from position limits was produce a copy of a contract requiring it to make or take physical delivery of a commodity.<sup>148</sup>

Today, however, it is not so easy to identify who is hedging. Indeed, many traders operate physical trading businesses, but because of the complex algorithmic way in which certain hedging schemes are implemented, it can sometimes be impossible for traders to match their futures trading, lot-for-lot, with their actual physical trading. Thus, for example, a merchant in the energy business may decide to hedge its obligations to deliver United States heating oil by purchasing European gasoil; or the same merchant may feel that its risks are best hedged by purchasing a crack spread, which may be a short or long-dated long contract for West Texas Intermediate Oil and a short or long-dated short contract for No. 2 heating oil.

In other words, there are many different ways in which a party may decide to hedge and a regulatory regime which imposes position limits, but provides hedge exemptions, must be able to differentiate between legitimate hedges and subterfuges designed to speculate.

Once again, MG offers a case in point. Back in 1993, the NYMEX had position limits for speculators.<sup>149</sup> MG, however, wanted to be exempt from such limits on the ground it was “hedging.” The purported basis for its hedge exemption was its having entered into ten-year contracts with consumers to sell gasoline and heating oil at fixed prices, but under terms by which the consumers did not have

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<sup>148</sup> *Position Limits for Derivatives*, *supra* note 1, at 195.

<sup>149</sup> Dan M. Berkovitz, *Background on Position Limits and the Hedge Exemption*, COMMODITY FUTURES TRADING COMMISSION 5 (Jan. 14, 2010), available at [http://www.cftc.gov/PressRoom/SpeechesTestimony/proposedrule011410\\_berkovitz](http://www.cftc.gov/PressRoom/SpeechesTestimony/proposedrule011410_berkovitz).

to take any delivery until thirty days prior to expiration of the ten-year term.<sup>150</sup>

In the meantime, if at any time during the ten year period the price of gasoline or heating oil exceeded the fixed price in the contract, the consumer could sell back the contract and receive the difference between the actual price and the fixed price, multiplied by the total amount of gallons that otherwise would be delivered. Consumers paid nothing for these “contracts,” but MG used them to obtain hedge exemptions entitling them to be excused from position limits intended to curb speculation.<sup>151</sup> That these contracts were mere pretexts by which MG was allowed to engineer one of the biggest oil speculations in history went unnoticed by NYMEX, which unwittingly blessed these exemptions.<sup>152</sup>

The problem, in other words, is that once you impose position limits, you must also allow for hedge exemptions and it is difficult to imagine how the government could administer such a regime without either erring on the side of granting such exemptions in almost every case, not wishing to second-guess a company’s hedging strategy or, alternatively, the government refuses to grant the exemption, in which case a legitimate price risk may not be capable of being shifted. If that occurs, there is the very real prospect that consumers will have to pay higher prices to compensate the seller for the risk it could not hedge that prices might rise, or, alternatively, as suggested earlier, a new market emerges in which hedge exemptions themselves are bought and sold, and such costs are likewise passed on to consumers

Yet the CFTC insists that position limits are the answer. It has promulgated a rule change, for the second time, hoping that it has addressed the concerns raised by the court that struck down its position limits proposal last year, and given the controversy raised by the proposal, it is virtually certain that the revised rules will again be challenged legally and the CFTC will have to justify why it believes it is legally entitled to mandate position limits in the absence of any empirical evidence demonstrating that they are either necessary or appropriate to address any real problem in the futures markets. How-

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<sup>150</sup> MARK WAHRENBURG, HEDGING OIL PRICE RISK: LESSONS FROM METALLGESELLSCHAFT 3 (1995).

<sup>151</sup> Edward N. Krapels, *Re-examining the Metallgesellschaft affair and its implication for oil traders*, OIL & GAS J. (March 26, 2001), <http://www.ogj.com/articles/print/volume-99/issue-13/special-report/re-examining-the-metallgesellschaft-affair-and-its-implication-for-oil-traders.html>.

<sup>152</sup> *Id.*

ever, it may be time to take a closer look at whether such regulation is really needed and whether there are other more surgical remedies that the CFTC may wish to consider implementing instead.