

Comment Regarding Position Reports for Physical Commodity Swaps

In response to U.S. Commodities Futures Trading Commission November 2, 2010 Notice of Proposed Rulemaking

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One of the major causes of the 2008-09 financial market crisis, and the formation of the speculative bubble that preceded the crisis, was that there were major gaps in the types of activities that fell under the then existing financial regulatory regime. Correspondingly, one of the most important features of the new Dodd-Frank financial regulatory regime will be to extend the regulatory standards to cover all relevant financial market activities.

Further, one of the most effective regulatory tools available to the CFTC and other regulatory bodies is to establish position limits for traders. When there are limits on the position that can be held by any one trading organization, this prevents large traders from establishing a dominant market position. If a single trader is able to establish a dominant market, that in turn can enable them to manipulate prices to their advantage. For example, a single trading firm whose position constitutes a large share of overall trading can then choose to increase price volatility in the market. In turn, such volatility could elicit changes in margin requirements. In such circumstances, smaller trading entities could become incapable of meeting the more stringent margin requirements. This could then enable the larger trader—which had been responsible for creating the greater price volatility in the first place—to establish a still stronger degree of market control.

Given that such scenarios are real possibilities when trading is insufficiently regulated, it is of great importance that the CFTC is proceeding in establishing position limits for designated contract market (DCM) physical commodity futures contracts and swaps that are economically equivalent to such contracts. We understand that the CFTC's recommendation on how exactly to implement these position limits will be forthcoming in the coming weeks.

We also understand that, for the moment, the CFTC is only considering the data and reporting requirements that they will establish, whose purpose will be to provide a solid empirical foundation for setting effective position limits on heretofore unregulated activities. In general, we strongly support the proposal published by the CFTC which reads as follows:

The Commission currently receives, and uses for market surveillance purposes, including position limit enforcement, data on large positions in physical commodity futures and option contracts traded on DCMs. However, there is no analogous reporting structure in place for economically equivalent swaps, which until recently were largely unregulated financial contracts. *The Commission's proposal would require position reports on economically equivalent swaps from clearing organizations, their members, and swap dealer* (Federal Register, 11/2/10, emphasis added).

One possible area of concern is that the requirement may only apply to firms holding “large positions,” in swaps, as well as other futures and option contracts traded on DCMs. In our view, it is important for the CFTC to maintain a clear sense of *all* market activity in futures, options and swaps, not just that of large traders. At the simplest level, it will not be possible to discern the extent to which “large” traders are able to establish excessive power in a given market setting until we observe the full extent of market activity. That is, the “large” trading units can only be seen as “large” unless we are able to compare them with other, smaller, units. As such, it is crucial that position reporting requirements extend not just to large traders, but to all traders in the market.

Beyond this one point, we endorse this initiative of the CFTC as one crucial step toward establishing an adequate data foundation on which to implement effective regulations of the commodities futures markets.