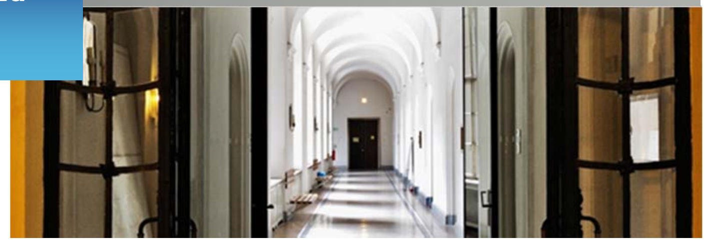
# Implementation of CFTC's Position Limits Could Stymie Commodity Derivatives Investment



In recent years, commodity investing has become increasingly important for several reasons. Investors—especially those with long horizons, such as pension funds—seek hedges against inflation, and commodities are one of the asset classes that have historically filled that role. Commodity returns have also historically had a low correlation with equity and bond returns, providing diversification benefits to traditional long-only equity and fixed income portfolios.

Against this backdrop, enhanced regulation of the commodity derivatives markets has been on the agenda of elected officials and regulators since the oil and food price spikes in 2008. This push for increased regulation has more recently been melded into the broader objectives of financial regulatory reform: increased transparency and systemic risk reduction. In February 2011, the G-20 Group of Finance Ministers indicated that commodity derivative markets regulation represented a top priority. The replay of high commodity prices in the first half of 2011 only adds to the political pressure on regulators to implement measures that could affect investors' access to this asset class, as some observers contend (without empirical support - See Sidebar on Page 3) that increased investor participation in commodity markets pushes prices higher.

One key factor impacting the regulatory debate on commodity derivative markets is that there is a greater diversity among participants in these markets as compared to derivative markets in other asset classes. Producers of commodities—such as mining companies, oil producers and farmers—use commodity derivatives markets to manage the risks to which they are exposed. Similarly, users of commodities—such as airlines, food companies and manufacturers—also use commodity derivatives for risk management. Non-commercial participants—that is, dealer intermediaries, and passive and active investors—perform the important role of taking on the commercial risks that producers and users need to manage. As a result, we believe it is critical that any changes to the regulatory regime for these products recognize both the diversity of participants and the important role investors play in these markets.

Financial regulatory reform in the US is framed by the enactment in July 2010 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank Act"). This legislation will bring over-the-counter (OTC) derivatives markets, swap dealers and other market participants under the regulatory oversight of the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC), once Dodd Frank-mandated rulemaking is completed.  At that point, the US OTC commodity derivatives markets will more closely resemble futures markets—with central clearing of standardized derivatives, trading on exchanges or swap execution facilities, and increased price and trade reporting.

Across the Atlantic, the European Commission has begun in earnest its review of commodity derivative markets with similar objectives in mind. A detailed proposal is expected by October 2011, and we believe that European officials will clearly look to the CFTC's implementation of its Dodd Frank Act mandates as a template for their own. In fact, cross-border harmonization of rules is of paramount concern to both regulators and market participants given the global nature of these markets.

In this *ViewPoint*, we provide historical background on commodity derivatives market regulation, examine the CFTC's current proposal and assess the ways in which the new regulatory regime could impact investors.

## Background

Commodity derivatives (exchange-traded futures and OTC swaps and derivatives) are used by commercial firms (producers and users) to manage price risk and by investors to profit from price movements. It is generally agreed that investors provide essential liquidity to these markets. Historically, the CFTC (for certain enumerated agricultural commodities) and the futures exchanges have established "position limits" or "position accountability levels" in order to protect against disorderly markets and excessive speculation. Position limits prohibit a trader from holding a futures position above a specified limit, unless the trader has received an exemption, usually based on hedging activity. Position accountability levels are a tool used by futures exchanges to monitor their markets, and in general the exchanges can require a trader to reduce his or her positions if they believe the current holdings are excessive or may contribute to unwarranted price volatility.

Under the Dodd Frank Act, CFTC jurisdiction was expanded to include OTC commodity derivatives, as well as other OTC derivatives (other than those derivatives which are defined as "securities-based", for which authority was granted to the SEC consistent with prior precedent). Under the Dodd Frank Act, the CFTC is directed to develop positions limits "as appropriate" across all physical commodity derivatives. In January 2011, the CFTC proposed a rule to establish position limits for metals, agricultural and energy derivatives.

As discussed below, this proposal goes beyond setting federal limits on 28 commodity derivatives[1] contracts by repealing or substantially modifying longstanding independent account controller exemptions and position aggregation rules. While the proposal sets the initial position limits for these commodity derivatives at a high level, we believe the effect of the proposed aggregation changes will result in multiple counting of the same position toward the limit. The proposed position limits will therefore be significantly more constraining on investors than they first appear.

Position limits have not generally served as a regulatory tool for commodity futures markets outside of the US, although most futures exchanges do use position accountability level or similar monitoring practices to protect their markets. However, the European Union's pending Markets in Financial Instruments Directive (MiFID) review of commodity derivatives suggests that eurozone futures and OTC derivatives activity could soon be subjected to position limits as well, in response both to concerns about commodity price levels and also to curtail opportunities for "regulatory arbitrage" between the US and the EU.

[1] Cocoa, Coffee, Corn, Cotton No. 2, Feeder Cattle, Frozen Concentrated Orange Juice, Lean Hogs, Live Cattle, Milk Class III, Oats, Rough Rice, Soybeans, Soybean Meal, Soybean Oil, Sugar No. 11, Wheat (CBOT), Wheat-Hard Red Spring, Wheat-Hard Winter, Copper Grade #1, Gold, Palladium, Platinum, Silver, Crude Oil, Light Sweet (WTI), Gasoline Blendstock (RBOB), Natural Gas, No. 2 Heating Oil-New York Harbor

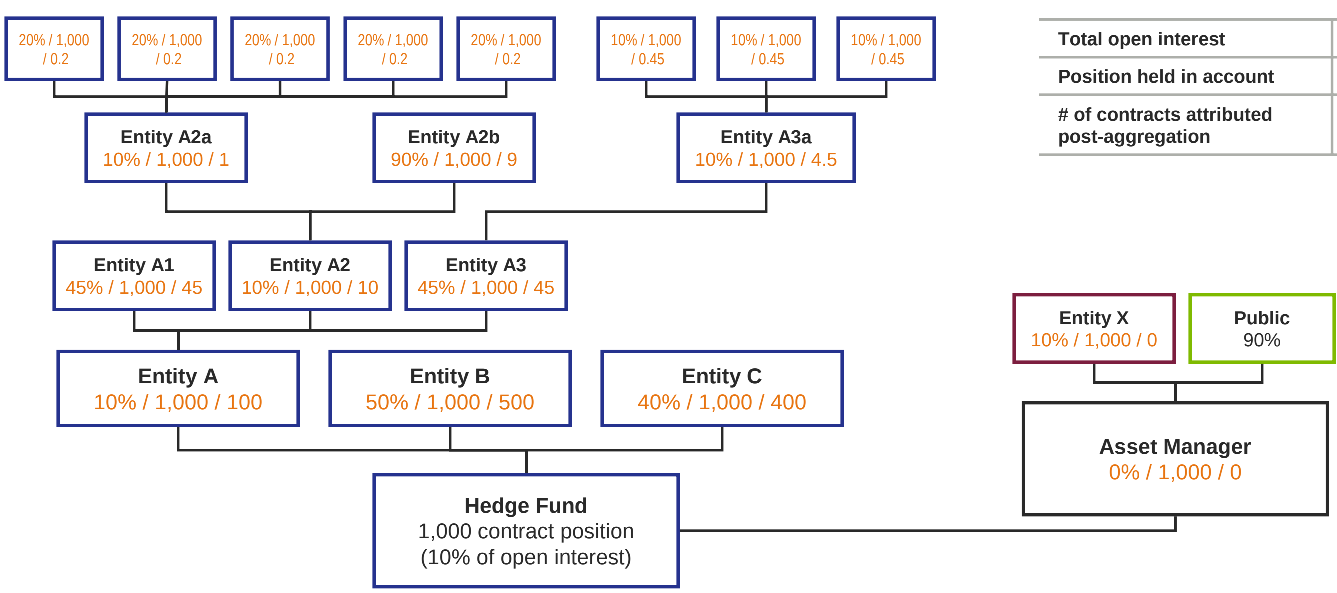
## The CFTC Proposal and Its Potential Impact

BlackRock fully supports the CFTC's efforts to prevent price manipulation and other illegitimate price distortions. Our concern is not with CFTC-mandated position limits themselves, but rather with the way in which the agency seeks to implement them.

Under the existing CFTC rules, positions are aggregated across entities (or not) principally based on a concept of who controls the trading—the decisions to buy or sell the position. This, in our view, is logical, as the concern underlying position limits and position accountability controls is the potential effect a trader may have on fair and orderly markets. However, this approach has now been largely abandoned, and in its place is an expanded concept of "control" based not only on trading control, but also on levels of ownership of the trading entity or levels of investment in an investment vehicle or fund—without requiring that the shareholder or the investor has control over trading decisions in any way. This expansion beyond trading control to include mere passive owners unnecessarily penalizes investors who have no control over trading decisions.

As illustrated in Figure 1, the CFTC proposal would require entities that either own 10% or more of a fund that trades commodity interests or is a 10% or more shareholder of an operating company, such as an asset management company, to aggregate the positions of the owned-entity, without regard to whether there is control over the trading decisions of the entity in which the investment is held.  In addition, the entire position of the investee entity is attributed to each investor, resulting in multiple reporting of what is the same position.

Figure 1: Six Degrees of Aggregation




| | |
|---|---|
| **Total open interest** | 10,000 |
| **Position held in account** | 1,000 |
| **# of contracts attributed post-aggregation** | 20,000 |

**NOTE:** Orange text represents:
% ownership of downstream entity / # of contracts attributed through aggregation / actual pro-rata economic interest in position

**Legend:**
Owns positions
Controls trading of positions
Neither owns nor controls positions

Source: Barclays Capital

As shown in this example, the effect of the expanded aggregation rules is to attribute 20,000 commodity contracts toward the position limit, when in fact total open interest is only 10,000 contracts. This artificial inflation of positions held by passive owners or investors counted toward the limit will needlessly restrict investors from participating in commodities markets.

The CFTC is also proposing to narrow hedge exemptions in such a way that the issuers of exchange-traded notes (ETNs) will no longer be eligible to qualify, so that their activities to protect themselves from their ETN obligations will count against their speculative limits. This, in our view, will likely result in few, if any, new commodity-linked notes being issued once the rule becomes effective. Further, changes in what qualifies as a bona fide hedge may constrain swap dealers, resulting in commodity-linked swaps becoming more scarce and more expensive for counterparties. (Grandfathering rules will protect existing swaps and outstanding ETNs.)

We believe the combination of a potentially broad aggregation policy with narrow disaggregation relief could cause both asset managers and investors to avoid the risk of inadvertently violating the CFTC-set limits by reducing their participation in CFTC-regulated markets. This will make it more difficult for investors to access this asset class. In addition, we believe that reduced participation will, in turn, result in reduced volume and liquidity in these markets, thereby hindering the markets' underlying price discovery function and efficient risk management by hedgers.

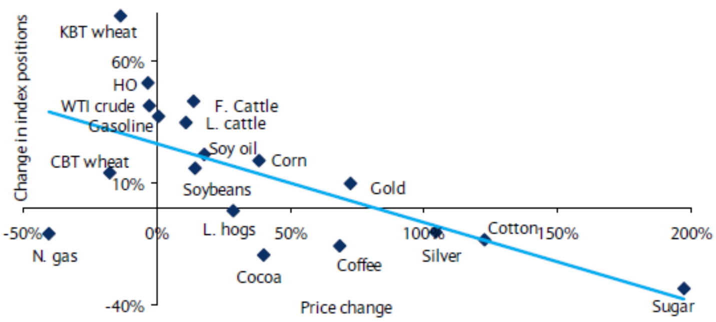
We have urged the CFTC to consider these consequences and, if position limits are to be adopted, to re-evaluate their approach to aggregation across entities. Investors should also make their concerns known to the CFTC. It is important to note that the European Commission will look closely at the final CFTC rules in fashioning their own proposals, so the decision in Washington could have broader implications.

## Commodity Index Strategies

Commodity index products come in a variety of forms, including private funds, separate accounts and exchange-traded products. Most are benchmarked to diversified and transparent commodity indices, and are based on passive, long-only fully collateralized commodity derivatives positions.

Studies of index investors have been unable to provide empirical evidence to support a causal connection between commodity index investing and the value of commodity futures. The studies have concluded that fundamental supply and demand is the underlying cause of price volatility, not speculators. As noted in Figure 2, for most commodities, index buying is not associated with rising prices.

Figure 2: Change in Index Positions versus Price Change in US commodity markets




Source: CFTC, Barclays Capital



BLACKROCK®