Dissenting Statement of Commissioner Dan M. Berkovitz Regarding Final Rule on Position Limits for Derivatives

I. Introduction

I dissent from today's position limits final rule ("Final Rule"). The Final Rule fails to achieve the most fundamental objective of position limits: to prevent the harms arising from excessive speculation. It is another disappointing chapter in the Commission's 10-year saga to implement Congress's mandate in the Dodd-Frank Act to impose speculative position limits in the energy, metals, and agricultural markets. In a number of instances, the Final Rule appears more intent on limiting the actions and discretion of the Commission than it does on actually limiting such speculation.

As I previously observed, the proposed rule demoted the Commission from head coach to Monday-morning quarterback. The Final Rule declares that the players on the field are the referees. In this arena, the public interest loses.

I support effective position limits to restrain excessive speculation in physical commodity markets, coupled with legitimate bona fide hedge exemptions for commercial market participants. The Final Rule, however, fails to address excessive speculation in several key respects:

First, the Final Rule impermissibly permits private entities to devise new bona fide hedge exemptions, while simultaneously constricting the Commission's review and enforcement of such privately-created exemptions.

Second, the Final Rule fails to address trading at settlement ("TAS") transactions. The potential for market manipulation through the use of TAS is well documented. The Final Rule was a valuable but wasted opportunity to address an important type of transaction in many commodity markets that, if abused, can present risks to orderly trading and price discovery.

Third, while the Final Rule eliminates the risk management exemptions that had been granted to a limited number of index funds, it also increases the non-spot month limits to accommodate the speculative positions of these funds in the futures markets. Cumulatively, index funds can have a substantial price impact and exacerbate volatility. Their monthly position rolls can also distort inter-month spreads. Yet the Commission performed no assessment of the impact of potential increases in this type of speculation that these higher limits would permit.[1]

[1] For detailed comments on the effects of large speculative positions of index funds, *see* Better Markets Comments Letter, at 8-12 (May 15, 2020).

Fourth, the Final Rule misinterprets the Dodd-Frank Act and reverses decades of precedent by declaring, for the first time, that the Commission must make antecedent necessity findings on a commodity-by-commodity basis prior to imposing federal speculative position limits.

II. Physical Commodity Markets Benefit from Position Limits and Appropriate Bona Fide Hedge Exemptions

Position limits help prevent market manipulation and price distortion arising from excessively large speculative positions in futures, options, and swaps tied to physical commodities. Section 4a of the CEA reflects Congress's long-standing determination that excessive speculation in a commodity can cause "sudden," "unreasonable," or "unwarranted" fluctuations and changes in commodity prices.[2] Section 4a directs the Commission to establish speculative position limits to address these harms, while also providing that such limits shall not apply to "transactions or positions which are shown to be bona fide hedging transactions or positions, *as those terms are defined by the Commission . . . .*"[3]

Experience from decades of limits in agricultural commodities teaches that a properly crafted position limits regime is an "effective prophylactic measure" to protect American businesses, consumers, and market participants that rely on physical commodity derivatives markets.[4] The parameters of an effective position limits regime are well established. They include: (1) meaningful limits on excessive speculation to help prevent market manipulation and price distortion; (2) recognition of bona fide hedging activities and exemptions to permit producers, end-users, merchants, and others to manage their commercial risks; and (3) clear divisions of responsibility, consistent with the CEA, that recognize the complimentary but distinct roles of exchanges, the Commission, and market participants in administering a position limits regime.

Federal speculative position limits have been in place to protect derivatives markets since the 1930s. The Commission or its predecessors adopted position limits for grains in 1938, cotton in 1940, and soybeans in 1951. In 1981, the Commission adopted rules requiring exchange limits for all commodities for which there were no federal limits—a rule which notably did not require an antecedent, commodity-by-commodity necessity finding. The Commission has also consistently relied on exchanges to help administer the position limits regime, including position accountability and enumerated bona fide hedge exemptions.

These efforts, spanning over 80 years, have helped prevent manipulation and price distortion through a complementary system that relies on the respective expertise of Commission, exchange, and market participant stakeholders. The Final Rule discards this balance. The Final Rule relies excessively on exchanges and market participants to permit positions as bona fide

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[2] 7 U.S.C. 6a.

[3] 7 U.S.C. 6a(c)(1) (emphasis added).

[4] Establishment of Speculative Position Limits, 46 FR 50938 (Oct. 16, 1981).

hedges, and in so doing impermissibly delegates the Commission's statutory responsibility to determine what constitutes a bona fide hedge.[5]

III. Significant Flaws in the Final Rule

A. The Final Rule Permits Market Participants to Violate Federal Speculative Position Limits with No Prior Commission Recognition of a Bona Fide Hedge Exemption

The Final Rule explicitly permits market participants to violate federal speculative position limits with no bona fide hedge exemption from the Commission. It impermissibly delegates the Commission's statutory responsibility to define bona fide hedging to the very market participants with large speculative positions that section 4a is intended to restrain, as well as to the exchanges, who have no authority to determine what is a hedge under federal law.

First, the Final Rule authorizes market participants to create their own bona fide hedge exemptions and exceed speculative position limits for "sudden or unforeseen increases in their bona fide hedging needs." No prior approval from the Commission or an exchange is required to exceed the limits established by the Commission, and market participants may file their hedge applications up to five days *after* violating the applicable position limit. The Final Rule offers no guardrails on what can be considered a "sudden or unforeseen" circumstance. In an efficient market, all future price movements are inherently unforeseeable; that is the reason for hedging to begin with.[6] Further, in today's interconnected markets, where the speed of light is the limiting factor on the transmission of information, sudden and unforeseen circumstances arise virtually every millisecond. This provision may swallow the Final Rule.

Second, the Final Rule authorizes a market participant to exceed *federal* speculative positon limits if an exchange permits it to exceed the *exchange's* position limits. In other words, an exchange determination can enable a market participant to violate *federal* limits even in the absence of a Commission determination. Here again, the Final Rule ignores the Commission's statutory responsibility to define bona fide hedging. Exchanges have a critical role in any

[5] "[W]hile federal agency officials may sub-delegate their decision-making authority to subordinates absent evidence of contrary congressional intent, they may not sub-delegate to outside entities—private or sovereign—absent affirmative evidence of authority to do so.'' *U.S. Telecom Ass'n v. FCC*, 359 F.3d 554, 565–68 (D.C. Cir. 2004) (citations omitted).

[6] "The basic efficient market hypothesis positions that the market cannot be beaten because it incorporates all important determining information into current share prices. Therefore, stocks trade at the fairest value, meaning that they can't be purchased undervalued or sold overvalued. The theory determines that the only opportunity investors have to gain higher returns on their investments is through purely speculative investments that pose a substantial risk." J. B. Maverick, The Weak, Strong, and Semi-Strong Efficient Market Hypotheses, Investopedia, available at https://www.investopedia.com/ask/answers/032615/what-are-differences-between-weak-strong-and-semistrong-versions-efficient-market-hypothesis.asp (updated Sept. 30, 2020). The unpredictability of the market has long been recognized. "If you can look into the seeds of time, and say which grain will grow and which will not, speak then unto me." William Shakespeare, Macbeth, Act 1, Scene 3 (1623).

properly balanced position limits regime, but they are not authorized by the CEA to define federal hedge exemptions, nor are they authorized to green-light violations of federal position limits.

This process for market participants to "self-recognize" non-enumerated hedges that they wish had been enumerated under federal law undoes the existing, Commission-led procedures that have worked well for decades.

The Final Rule reflects a multi-year, iterative process of notice and comment rulemaking to comprehensively determine which practices should constitute bona fide hedging. Members of the public and industry participants have enjoyed multiple opportunities to inform the Commission on this topic, including through additional proposed position limits rules in 2013 and twice in 2016. The Final Rule's enumerated hedges reflect the Commission's extensive dialogue and reasoned deliberations, and they recognize a wide array of hedging practices identified by commenters. To my knowledge, the Commission is not aware of any novel hedging practices that were not addressed during this rulemaking process.

Commission regulations currently allow for the recognition of non-enumerated bona fide hedges through a 30-day, Commission-led review process. The Commission must recognize the requested hedge as bona fide before a market participant can put the hedge on the exchange and exceed position limits. This process has worked well for decades. The Final Rule replaces it with a new system that allows market participants to make their own bona fide hedge determinations and exceed federal position limits in advance of any reasoned, considered evaluation by the Commission.

1. <u>The 10 and 2 Day Review Periods are Inadequate for the Commission to Consider Applications for Exemptions after an Exchange Determination</u>

The Final Rule attempts to cure the impermissible statutory delegation described above through crammed, after-the-fact reviews of market participants' hedge applications and violations of position limits rules.

Market participants who request prospective non-enumerated bona fide hedge exemptions from an exchange may violate federal speculative position limits upon being granted the exemption. The exchange must then forward the application and other materials to the Commission for the beginning of a constricted 10-day review period.

The Commission, for its part, must complete the difficult task of evaluating the law, facts, and circumstances with respect to cash market risks that have already been incurred and commodity positions that have already been posted on an exchange. Commission determinations regarding the validity of positions that have already been entered into will be complicated by the commercial implications involved in unwinding such positions. Further, in the event that the Commission determines to deny the application, the Commission must provide the applicant with notice and opportunity to respond. In the case of positions established due to "sudden or unforeseen" events, the Final Rule calls for a two-day review. This is an unrealistic and unworkable timeframe. This fig leaf of a "review" cannot provide legal cover for the impermissible delegation.

2. The Final Rule Adopts a Policy of Non-Enforcement for Position Limit Violations

Both the rule text and the preamble to the Final Rule leave no doubt that any person who puts on a position in excess of a position limit prior to receiving Commission approval of the exemption is in violation of the speculative position limits. However, where an application for a non-enumerated bona fide hedge is submitted retroactively to either an exchange or the Commission due to "sudden or unforeseen circumstances," or where an exchange has approved an application for an exemption from the exchange limit, the Commission limits its ability to prosecute such violations by declaring that, "as a matter of policy," it will not pursue an enforcement action as long as the application was submitted in "good faith."

The Final Rule does not define "good faith." Perhaps this is because the concept of good faith traditionally is used as a safe harbor to protect persons who reasonably believe they are acting in compliance with the law. For example, when exercising its prosecutorial discretion for violations of the swap dealer business conduct standards, the Commission considers whether the swap dealer attempted in "good faith" to follow policies and procedures reasonably designed to comply with the CEA and Commission Regulations.[7] This application of the good faith doctrine is consistent with the long-established understanding of the term.[8] In the Final Rule, however, the Commission turns this doctrine on its head and mandates prosecutorial discretion where a market participant knowingly acts *in violation* of the law by putting on a position in excess of the legal limit.

Notably, the Commission describes its position not to enforce these violations as "a matter of policy." So although this non-enforcement policy is adopted as part of this rulemaking, it is nonetheless just that—a statement of policy. As the Supreme Court has recognized, "general statements of policy," or "statements issued by an agency to advise the public prospectively of

[7] *See* Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties, 77 FR 9734, 9744, 9746, 9750 (Feb. 17, 2012).

[8] *See, e.g.*, *CFTC v. Monex Credit Co.*, No. SACV-171868, 2020 WL 1625808, at *4-5 (C.D. Cal. Feb. 12, 2020) (finding that controlling persons did not establish good faith defense to liability under 7 U.S.C. 13b where they knowingly or recklessly violated the CEA or were aware or should have been aware that employees were violating the CEA, or did not reasonably enforce system designed to promote legal compliance) (citing *Monieson v. CFTC*, 996 F.2d 852, 860-861 (7th Cir. 1993)); *U.S. v. Leon*, 468 U.S. 897 (1984) and *Massachusetts v. Sheppard*, 468 U.S. 981 (1984) (establishing good faith doctrine as exemption to Fourth Amendment exclusionary rule when police officer reasonably believed conduct to be legal).

the manner in which the agency proposes to exercise a discretionary power," are not subject to the notice-and-comment procedures of the Administrative Procedure Act.[9] Accordingly, the Commission may change this enforcement policy at any time without engaging in a notice-and-comment rulemaking.

Significantly, in its comment letter, the entity with the most experience in retroactive applications for hedge exemptions, the CME Group, pointed out to the Commission the importance of being able to take enforcement action for position limit violations that have occurred when retroactive applications are denied. It stated:

> Today at the exchange level, CME Group considers firms to be in violation of a position limit if they exceed a limit and the exemption application is denied. We believe the Commission should implement this standard rather than permitting the proposed grace period for denial of an exemption application. Otherwise, market participants with excessively large speculative positions could exploit the grace period accompanying an application for an exemption and intentionally go over the applicable limit without consequences—all the while disrupting orderly market operations. In our experience, the prospect of having an application denied and being found in violation of position limits has worked to deter market participants from attempting to exploit the retroactive exemption process.[10]

Although the Final Rule is replete with deference to the experience of the exchanges in implementing the position limits regime, and creates a process specifically reliant upon the exchange's expertise in granting hedge exemptions, here in the context of enforcing violations and deterring abuse, the Commission oddly rejects that expertise.

B. <u>The Final Rule Fails to Address TAS Transactions or the Historic Collapse of WTI Crude Oil Futures</u>

On April 20, 2020, the price of the May futures contract for West Texas Intermediate ("WTI") crude oil traded on the New York Mercantile Exchange collapsed from \$17.73 per barrel at the market open to a closing price of *negative* \$37.63. This single-day fall in prices of approximately \$55 per barrel is unprecedented, and was accompanied by a massive disconnect between May crude oil futures and the price of crude oil in the physical market.

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[9] Nor are blanket statements of policy that abandon an agency's responsibility to enforce the law constitutionally permissible. *Crowley Caribbean Transp., Inc. v. Peña*, 37 F.3d 671, 677 (D.C. Cir. 1994) ("[A]n agency's pronouncement of a broad policy against enforcement poses special risks that it 'has consciously and expressly adopted a general policy that is so extreme as to amount to an abdication of its statutory responsibilities.'") (citing *Heckler v. Chaney*, 470 U.S. 821, 833 n.4 (1985)).

[10] CME Comment Letter (May 14, 2020).

WTI crude oil futures are a key benchmark in global energy markets and can impact the overall U.S. economy. Following the WTI event, I called upon the Commission to determine the causes of this unprecedented price movement and divergence from physical markets, and to work with CME to "take whatever measures may be appropriate to ensure that trading in the WTI futures contract is orderly and supports convergence of the futures and physical markets."[11] Almost six months later, the Commission has yet to complete its investigation or issue even preliminary results. It should not take this long for the world's leading derivatives regulator to understand the historic collapse of a benchmark contract that it has overseen for decades.

Independently of the Commission's investigation, public commentary following the WTI event focused on TAS transactions and the well-known integrity concerns regarding TAS under certain market conditions.[12] TAS transactions represent the purchase or sale of an underlying exchange commodity at the closing price for that commodity or at a specified differential. Notably, exchange rules may permit TAS transactions to be netted intraday against futures positions in that commodity established via outright purchases and sales. Such netting could permit a trader to establish very large long or short positions in the outright futures contracts, while remaining below speculative position limits on a net basis.

The Final Rule recognizes the importance of netting practices and rules in several regards. For example, it prohibits the spot-month netting of physically settled contracts with linked cash settled contracts. The Final Rule explains that allowing such netting during the spot month "could lead to disruptions in the price discovery function of the core referenced futures contract or allow a market participant to manipulate the price of the core referenced futures contract." The Final Rule is silent, however, with respect to any limitations on the netting of TAS with outright futures.

One commenter on the Final Rule reminded the Commission in significant detail of the market integrity issues associated with TAS orders.[13] But even apart from the comment letters on the

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[11] Statement of Commissioner Dan M. Berkovitz on Recent Trading in the WTI Futures Contract before the Energy and Environmental Markets Advisory Committee Meeting (May 7, 2020), available at https://www.cftc.gov/PressRoom/SpeechesTestimony/berkovitzstatement050720.

[12] *See, e.g.*, Matt Levine, It's a Good Time to Cut Dividends, Money Stuff (Apr. 29, 2020), available at https://www.bloomberg.com/news/articles/2020-08-04/oil-s-plunge-below-zero-was-500-million-jackpot-for-a-few-london-traders?sref=DzeLiNol ("If you combine these two facts—a lot of TAS contracts and not much volume around the settlement time—you get a well-known theoretical problem. . . . The basic pattern—agree in advance to buy (sell) stuff at the official settlement price at some fixed future time, and then sell (buy) a bunch of that stuff in the minutes leading up to the official settlement time with the effect of pushing down (up) the price at which you are buying (selling)—is incredibly common . . . ."); Craig Pirrong, Streetwise Professor Blog, WTI-WTF? Part 3: Did CLK20 Get TAS-ed? (Apr. 30, 2020), available at https://streetwiseprofessor.com/2020/04/.

[13] Better Markets Comment Letter, at 13-14 (May 15, 2020).

proposed rule, and apart from the WTI event, the potential for manipulation through the use of offsetting TAS contracts has been well-known.[14] Further, the CFTC has direct experience with this issue: it has brought two manipulation cases where WTI TAS orders were an integral part of the manipulative scheme.[15] Given the Commission's familiarity with the potential for manipulation and disruption of the price discovery process arising from an abuse of the TAS order type, the failure of the Final Rule to address in any manner these well-known dangers to market integrity is inexcusable.

C. The Final Rule Misconstrues the CEA by Requiring Antecedent, Commodity-by-Commodity Necessity Findings Prior to Imposing Federal Position Limits.

The Final Rule misinterprets the Dodd-Frank Act and reverses decades of Commission interpretation and finds that an antecedent, commodity-by-commodity necessity finding is required prior to imposing federal speculative position limits. The Final Rule further states that this "is the best interpretation" of CEA section 4a(a)(2), and that the Commission's prior interpretations are "not compelling."

I addressed this issue extensively in my dissenting opinion on the proposed position limits rule, and I reiterate those views now.[16] Neither the statutory language of CEA section 4a(a)(2), nor the district court's decision in *ISDA v. CFTC*, require an antecedent necessity finding prior to imposing position limits. The Final Rule's new interpretation, which the Commission concedes is a "change" from prior interpretations, is mistaken.[17]

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[14] *See, e.g.*, Craig Pirrong, Derived Pricing: Fragmentation, Efficiency, and Manipulation, Bauer College of Business, University of Houston, at 10 (Jan. 14, 2019), available at https://streetwiseprofessor.com/2020/04/ ("The analysis in Section 2 demonstrates that TAS contracts create trading opportunities with asymmetric price impacts. This suggests that TAS may therefore also create opportunities for profitable trade-based manipulation, and this is indeed the case."); *see also* Paul Peterson, Trading at Settlement for Agricultural Futures: Results from the First Month, farmdoc daily (July 29, 2015), available at https://farmdocdaily.illinois.edu/2015/07/trading-at-settlement-for-agricultural-futures.html ("Over the years TAS has been associated with several efforts to artificially influence the daily settlement price through 'banging the close' and other forms of manipulation [citations omitted].").

[15] *See In re Optiver US LLC*, CFTC No. 08 Civ 6560, 2012 WL 1632613 (Apr. 19, 2012); *In re Shak*, CFTC No. 14-03, 2013 WL 11069360 (Nov. 25, 2013) (consent order).

[16] *See* Dissenting Statement of Commissioner Dan M. Berkovitz Regarding Proposed Rule on Position Limits for Derivatives (Jan. 30, 2020), available at https://www.cftc.gov/PressRoom/SpeechesTestimony/berkovitzstatement013020.

[17] Significantly, however, at the Commission's meeting on the proposal rule, the Commission's Office of General Counsel clarified that a necessity finding is required only with respect to the Commission's establishment of federal position limits. The Office of General Counsel stated that a necessity finding was neither a prerequisite for a Commission directive to the exchanges to establish limits, nor prior to establishing the standards for such limits. The Commission's legal interpretation in the Final Rule is identical to the interpretation in the proposed rule in this regard as well.

As articulated in my prior dissent, the Final Rule's interpretation of CEA section 4a(a)(2) "defies history and common sense."[18] Following hard on the heels of the 2008 financial crisis and the collapse of the Amaranth hedge fund in 2006, it is implausible that the drafters of the Dodd-Frank Act intended what the Commission has now adopted. The Final Rule requires the Commission to believe that a Congress in the midst of the financial crisis, aware the CEA had never been interpreted to require predicate necessity findings for position limits, and engaged in a historic effort to regulate financial markets, would nonetheless make it *harder* for the Commission to impose federal speculative position limits. The Commission's revisionist legislative history is neither accurate nor credible.

IV. Conclusion

The Final Rule departs from both legal interpretations and policy frameworks that have served commodity markets well for decades.

Most significantly, the Final Rule impermissibly delegates the authority to recognize non-enumerated hedge exemptions; provides farcically short review periods for private-entity hedge determinations; attempts to enshrine a policy of non-enforcement for position limits violations; fails to address the well-known risks of TAS transactions; and reinterprets the CEA to require antecedent necessity findings prior to imposing federal position limits.

I cannot support such a flawed rule.

[18] For a detailed discussion of how the Commission's necessity finding misconstrues the CEA as amended by the Dodd-Frank Act, *see* Dissenting Statement of Commissioner Dan M. Berkovitz Regarding Proposed Rule on Position Limits for Derivatives (Jan. 30, 2020), available at https://www.cftc.gov/PressRoom/SpeechesTestimony/berkovitzstatement013020b.