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Statement

"Position Limits and the Hedge Exemption, Brief Legislative History"

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July 28, 2009

Today, I will provide a brief legislative history of the mandate in the CEA concerning position limits and the exemption from those limits for bona fide hedging transactions.

Overview

Since its enactment in 1936, the Commodity Exchange Act (CEA) has stated that "excessive speculation" in any commodity traded on a futures exchange "causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity is an undue and unnecessary burden on interstate commerce" and has directed the Commodity Futures Trading Commission (CFTC) to establish such limits on trading "as the Commission finds are necessary to diminish, eliminate, or prevent such burden." The basic statutory mandate in Section 4a of the CEA to establish position limits to prevent such burdens has remained unchanged over the past seven decades.

Due to the increase in the number of commodities traded on the regulated futures exchanges, as well as changes in regulatory philosophy over the years, this mandate to establish position limits is currently being implemented in a variety of ways. The CFTC directly fixes the position limits for cotton, certain grain commodities, and the soybean complex; specifies acceptable practices for the exchanges to establish position limits for other commodities; and also allows the exchanges to use "position accountability levels" rather than fixed position limits in months other than the spot month for commodities that meet certain liquidity requirements.[1]

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[1] *See* 17 C.F.R. §150.5 (2009).

Since its enactment in 1936, the CEA also has exempted "bona fide hedging transactions" from any such position limits established under the Act. Initially, the CEA defined the term "bona fide hedging transactions" solely in reference to transactions in the cash market for a commodity. Since 1974, however, the Act has provided the Commission with discretion to define the term, provided that the Commission's definition enables producers, middlemen, and users of a commodity to hedge their legitimate anticipated business needs.

Position Limits

The enactment of the CEA of 1936 and the direction in Section 4a for the Commission to establish position limits was the culmination of a fierce debate that had raged for nearly twenty years—ever since the collapse in grain prices following the end of the First World War—over whether the Federal Government should impose limits on the trading of futures contracts.[2] The reasons for and purposes of Section 4a as it was enacted in 1936 are illuminated by examining not only the legislative history of the 1936 Act itself, but also the key aspects of the preceding twenty-year debate.

Food Control Act of 1917

The first exercise of Federal authority to limit trading in the commodity futures markets occurred when the Congress enacted emergency legislation to stabilize the U.S. grain markets during the First World War. Under the Food Control Act of 1917 the trading in wheat futures was suspended and the U.S. Food Administration "secur[ed] a voluntary limitation" of 500,000 bushels on the trading of futures contracts for corn.[3] After the war, Herbert Hoover, the wartime director of the U.S. Food Administration, testified that the limits on the trading of corn futures were "well carried out and during that period there was no manipulation of the market and no substantial interference with the normal processes of the hedging market."[4]

Future Trading Act of 1921

Many farmers and others blamed speculators, particularly the short sellers, for the continued depression in grain prices after the war. Many of these farmers sought the re-imposition of limits on trading. A number of bills were introduced in the Congress to regulate the grain markets, and the issue of whether to impose limits on the amount of speculative trading was vigorously debated.[5] Herbert Hoover, as the former director of

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[2] The debate over whether and how to control speculation in the U.S. grain markets can be traced back to the emergence of the organized markets for grain in the mid-19th century. See `William G. Ferris, *The Grain Traders, The Story of the Chicago Board of Trade* (Michigan State University Press, 1988). It was not until the First World War, however, that the Congress actually passed legislation imposing limits on speculation in a commodity market.
[3] Frank M. Surface, *The Grain Trade During the World War* (Macmillan, 1928), at p. 224; Testimony of Herbert Hoover, Hearing Before the House Committee on Agriculture, Future Trading, 66th Cong., 3d Sess (Jan. 20, 1921), at pp. 895-923.

[4] Id., at p. 895.

[5] Many bills to regulate the grain futures markets had been introduced and debated over the previous thirty years, but none had ever made it into law. In 1894 both the House and the Senate passed legislation that would have imposed a prohibitive tax on the trading of futures contracts. The bill died in the final days of the 52nd Congress after the

the U.S. Food Administration, testified that "my own inclination is to believe that as long as those speculative transactions are in comparatively small quantities they neutralize each other; it is only when a preponderant amount is handled by one hand that it can be made the instrument of manipulation."[6] Hoover supported position limits, and proposed to give the power to limit the size of individual speculative traders to a regulatory board under the Secretary of Agriculture.[7] The Secretary of Agriculture also supported regulation of the grain trade and limits on speculative trading.[8]

On the other hand, grain merchants, the grain exchanges and others in the grain industry believed that any regulation of the futures markets, including the setting of position limits, was not only unnecessary but would be harmful to the trade. One merchant urged Congress to resist "the phantom hope that the depression [in grain prices] was manipulative and temporary and could be checked."[9] The President of the Kansas City Board of Trade testified that "the organized grain exchange to-day is the most finely balanced commercial machine in America," that it was "as nearly separated from a selfish interest as it is possible to imagine in any organization where the human agency is involved," and that "any sort of legislation that is enacted will tend so greatly to reduce speculation as to make hedging a most difficult thing."[10]

In May 1921, the House of Representatives passed a bill requiring commodity exchanges to impose limitations on speculative trading as a condition of designation as a contract market. But the Senate rejected this proposal, and it was not included in the final bill that became the Future Trading Act in August 1921.

The 1921 Act proved to be short-lived. It was successfully challenged by members of the Chicago Board of Trade when the Supreme Court, in *Hill v. Wallace*,[11] declared

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bill's supporters were unable to muster a two-thirds majority in the House to suspend the rules to concur in the Senate version. See Cedric B. Cowing, *Populists, Plungers, and Progressives* (Princeton University Press, 1965), at p. 21.

[6] Testimony of Herbert Hoover, at pp. 900, 902.

[7] Hoover suggested a regulatory board "because there are more or less judicial questions to be determined." He noted that "it is a very, very difficult thing to set down rightful trade practices or prohibitions of trade practices with precision, and warned that legislation "may lead to wholly unexpected difficulties if the act attempts to get precision and too little flexibility." *Id,.* at p. 896

[8] Chester Morrill, Assistant Secretary of Agriculture, testified that the position limit provision in the House bill was included "as a result of suggestions made by the Secretary of Agriculture, "the thought being that the control of the market by speculative interests may occur through the volume of trading that may be concentrated in the hands of one person at one time, or, rather, not so much the volume of trading as the volume of open trades that may be concentrated in the hands of one person at one time, or, rather, not so much the volume of trading as the volume of open trades that may be concentrated." Hearings Before the Senate Committee on Agriculture, 67th Cong., 1st Sess., at pp. 17-18 (May 27, 1921).

[9] Testimony of Julius Barnes, Grain Exporter, Hearing Before the Senate Committee on Nutrition and Forestry, Future Trading in Grain, at p. 72 (May 31, 1921).

[10] Testimony of B.L. Hargis, President, Kansas City Board of Trade, 1921 Senate Hearing, at p. 239.

[11] Hill v. Wallace, 259 U.S. 44 (1922).

Section 4 unconstitutional as an improper use by Congress of its taxation power. Chief Justice Taft's opinion, however, suggested that such legislation might pass constitutional muster under the interstate commerce clause.[12]

Grain Futures Act of 1922

Within days of the court's decision, the Congress began the legislative process to remedy the constitutional defects identified by the Supreme Court. The Grain Futures Act of 1922 was nearly identical to the prior legislation, but, following the Supreme Court's cue, was based upon the commerce clause rather than the taxation power. In Section 3 of the Grain Futures Act Congress found that "sudden or unreasonable fluctuations" in the price of these transactions in grain futures that "frequently occur as a result of speculation, manipulation, or control" are "an obstruction to and a burden on interstate commerce," and thereby "render regulation imperative . . . in the national public interest."[13] Like its unconstitutional predecessor, however, the Grain Futures Act of 1922 did not provide the Federal Government with any authority to impose limits on trading.[14]

Congressional Debates and Studies, 1920s and 1930s

The debate over position limits continued throughout the 1920s and into the 1930s. Senator Capper, one of the original sponsors of the legislation that became the Futures Trading Act, introduced bills in each of the Congresses from 1925-1931 to amend the Grain Futures Act to impose limits on the positions that could be held by a single trader.

In 1926, as part of its comprehensive multi-year study of the grain markets, the Federal Trade Commission (FTC) concluded:

The very large trader by himself may cause important fluctuations in the market. If he has the necessary resources, operations influenced by the idea that he has such power are bound to cause abnormal fluctuations in prices. Whether he is more often right than wrong and more often successful than unsuccessful, and whether influenced by a desire to manipulate or not, if he is large enough he can cause disturbances in the

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[12] Chief Justice Taft's opinion stated: "[S]ales for future delivery on the Board of Trade are not in and of themselves interstate commerce. They cannot come within the regulatory power of Congress as such, unless they are regarded by Congress, from the evidence before it, as directly interfering with interstate commerce so as to be an obstruction or a burden thereon." 259 U.S., at 69.

[13] Grain Futures Act of 1922, § 3.

[14] The basic regulatory framework established by the Grain Futures Act remains in effect today. The Act required all grain futures contracts to be traded on a designated contract market, and set forth the conditions that the Secretary of Agriculture had to find were met in order to designate a board of trade as a contract market. Designation as a contract market was contingent upon a board of trade's providing for the prevention of manipulative activity and the prevention of dissemination of false information, upon providing for certain types of recordkeeping and for admission into exchange membership of cooperative producer associations, and upon location of the contract market at a terminal cash market. The Act authorized a Commodity Exchange Commission (CEC), consisting of the Secretary of Agriculture, the Secretary of Commerce, and the Attorney General, to revoke the designation of any board of trade that failed to comply with these conditions.

market which impair its proper functioning and are harmful to producers and consumers.[15]

The FTC recommended that limits be placed on trading, particularly on the amount of open interest that could be held by any one trader.[16]

The Department of Agriculture repeatedly urged the Congress to provide the Grain Futures Administration (GFA), which had been created by the Grain Futures Act, with the authority to impose position limits. In its study of the fluctuations in wheat prices during the early part of 1925, the GFA found that five large traders, each of whom were trading more than two million bushels of grain, were responsible for "wide and erratic price fluctuations" in the wheat futures market. Although the GFA's report emphasized the investigation "did not reveal any concentrated action for the deliberate purpose of manipulating the market," it stated that most of the wide and erratic price fluctuations "were largely artificial and were caused primarily, either directly or indirectly, by heavy trading on the part of a limited number of professional speculators."[17] In the letter of transmittal to the Senate, the Secretary of Agriculture and the Chief of the GFA reported that the harmful effect that these five large traders had on grain prices demonstrated the "the need for the development of some plan of limiting excessive speculative transactions."[18]

The 1926 Report was a pivotal development. Not only did it presage the distinction between manipulation and excessive speculation that survives in commodity regulation to this day,[19] it also marked the beginning of a series of recommendations by the GFA to Congress that the law be amended to require limits on speculative trading.[20] The

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[15] Report of the Federal Trade Commission on the Grain Trade, Vol. VII, *Effects of Future Trading* (1926), at pp. 293-4.

[16] The FTC stressed, "Limitation of the individual open interest is the most important point." *Id.* The FTC also identified the need to exempt hedgers from the limits: "Any proposed limitation of the size of the open interest, of course, does not apply to hedges. As regards quantity, hedges are self-limiting." The FTC also recommended reporting of large trades and the daily publication by the exchanges of volume and open interest.

[17] Fluctuations in Wheat Futures, 69th Cong., 1st Sess., Senate Document No. 135 (June 28, 1926).

[18] *Id.*

[19] The FTC report drew a similar distinction.

[20] For example, in 1931 Dr. J. W. T. Duvel, Chief of the GFA, testified as to his view of what constituted "excessive speculation":

> [W]ith these large-scale operations you may have a thousand traders outside scattered all over the entire country who may be buying and selling, but yet an individual speculator may come and sell more than the entire thousand combined and do it all in one day. In other words, the individual speculator may be entirely right in his own judgment as to values . . . . yet he has no choice. . . .
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> We find a great many cases where individual traders may do 8, 10, and sometimes 15 percent of the total day's business. . . . We do not think that anybody is entitled to do 10 percent of the day's business if it is to be a free and open world market. . . .
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> When large traders come into the market and buy or sell four or five million bushels one day or two days, that is excessive speculation and serves no useful purposes. In fact, it is detrimental. That is the reason we favor some limitations.

finding in the 1926 study that trades in excess of two million bushels caused “wide and erratic” price fluctuations became the basis for a number of proposals to establish a position limit of two million bushels, which eventually became the position limit for wheat that was established under the Commodity Exchange Act of 1936.

Another key legacy of the GFA’s 1926 report, as well as the FTC’s report of that same year, is the identification of the concept that large speculative positions, even without manipulative intent, can cause “disturbances” and “wild and erratic” price fluctuations. Both reports recommended that limits on trading be imposed to prevent large speculative positions regardless of the trader’s intent.

Commodity Exchange Act of 1936

The stock market crash that began in 1929, the Great Depression, and the election in 1932 of Franklin Roosevelt as President brought significant new momentum to the efforts to impose speculative position limits on the trading of commodities. In 1934, President Roosevelt sent a formal message to the Congress recommending the regulation of the securities and commodities markets to protect investors, safeguard values, and prevent “destructive speculation”:

It is my belief that exchanges for dealing in securities and commodities are necessary and of definite value to our commercial and agricultural life. Nevertheless, it should be our national policy to restrict, as far as possible, the use of these exchanges for purely speculative operations.

I therefore recommend to the Congress the enactment of legislation providing for the regulation by the Federal Government of the operations of exchanges dealing in securities and commodities for the protection of investors, for the safeguarding of values, and so far as it may be possible, for the elimination of unnecessary, unwise, and destructive speculation.[21]

Dr. Duvel again recommended a position limit of two million bushels. Hearings Before the Senate Agriculture Committee, 71st Cong., 3d Sess., at pp. 37, 42, 52 (February 10, 1931). See also Rodger R. Kaufman, *Legislative History of the Commodity Exchange Act* (November 1964), at p. 41 (unpublished manuscript).

[21] *Reprinted in* Report of the House Committee on Interstate and Foreign Commerce, Securities Exchange Bill of 1934, H. Rep. No. 1383, 73d Cong., 2d Sess., at pp 1-2 (April 27, 1934). The Congressional findings in the Securities Exchange Act of 1934 and the Commodity Exchange Act of 1936 were very similar; both were modeled after the findings in Section 3 of the Grain Futures Act. In Section 2 of the Securities Exchange Act the Congress found that the prices of securities “are subject to manipulation and control, and the dissemination of such prices gives rise to excessive speculation.” It also found:

> National emergencies, which produce widespread unemployment and the dislocation of trade, transportation, and industry, and which burden interstate commerce and adversely affect the general welfare, are precipitated, intensified, and prolonged by manipulation and sudden and unreasonable fluctuations of security prices and by excessive speculation on such exchanges and markets, and to meet such emergencies the Federal Government is put to such great expense as to burden the national credit.

Securities Exchange Act of 1934, June 6, 1934, c. 404, Title I, § 2, 48 Stat. 881.

After passing the Securities Act of 1933 and the Securities Exchange Act of 1934, the Congress considered legislation to strengthen the regulation of commodity markets, including whether to impose position limits on speculative trading in the futures markets for grain. Like the debates throughout the 1920s, opinions sharply differed as to whether regulation could better be accomplished by the exchanges rather than by a federal agency,[22] whether speculators were to blame for depressing grain prices, and whether the imposition of limits on speculation would impair the ability of grain merchants and others in the grain business to hedge. By the mid-1930s, however, the tide of opinion had turned. In addition to the depression in farm prices,[23] the inability of the exchanges and federal authorities to challenge the activities of a few prominent large traders fueled the reform movement, and the Congress finally provided a federal regulatory authority with the mandate and authority to establish and enforce limits on speculative trading.[24] In Section 4a of the 1936 Act (CEA), the Congress found that excessive speculation in the commodity futures markets created an "undue and

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[22] For example, the Chicago Board of Trade, testified that it "cannot accept under any circumstances in principle" any of the following: (1) limitations on speculation; (2) "The delegation of practically unlimited power to the Secretary of Agriculture, through rules and regulations to be promulgated as he sees fit;" (3) "The effort to put into effect a complete licensing system for the grain trade under the guise of registration;" and (4) special privileges for farm cooperatives. When asked why the Board of Trade supported delegation of virtually unlimited power to one of its own committees while at the same time objecting to the bill on the grounds that it delegated limited and defined authority to the Secretary of Agriculture, Mr. C.D. Sturtevant, testifying on behalf of the Board, stated, "We think we can do a better job." Hearing Before the Senate Committee on Agriculture and Forestry, To Amend the Grain Futures Act, 74th Cong., 1st Sess. (April 21, 1936), at p. 26. Senator Capper framed the issue: "I take it that your position all hangs on this point, that you want the board of trade to make all the rules and regulations governing the grain trade rather than an impartial agency of the Government that will function in the interest of all parties interested?" *Id.*, at p. 36. Siebel C. Harris, Vice President of the CBOT, sought to clarify that he had no objection to government regulation, but that the uncertainty in the market over what the government might do would be harmful to the market. "It is not my objection to what this Grain Futures Administration will do but it is the traders' objection to what they think any commission may do." *Id.,* at p. 37.

[23] In 1932, President Hoover blamed short sellers for the price declines on the grain exchanges:

> It has come to my attention that certain persons are selling short in our commodity markets, particularly in wheat . . . I refer to a limited number of speculators. . . . It has but one purpose, and that is to depress prices. It tends to destroy returning public confidence. The intent is to take a profit from the losses of other people. Even though the effect is temporary, it deprives many farmers of their rightful income. If these gentlemen have that sense of patriotism that outruns immediate profit, and a desire to see their country recover, they will close these transactions and desist from their manipulations.

William G. Ferris, *The Grain Traders, The Story of the Chicago Board of Trade*, at p. 195 (Michigan State University Press, 1988).

[24] Perhaps the most notorious large trader during this period was Arthur Cutten. To avoid the GFA's requirement to report positions in excess of 500,000 bushels of grain, Cutten established 32 separate accounts, with seven different firms, in the names of friends and relatives, in amounts up to a maximum of 495,000 bushels. On a number of occasions Cutten bought or sold several million bushels of wheat; at one point Cutten held a short position of about 7 million bushels. In 1932, Cutten wrote, "The notion that I could buy or sell not more than 500,000 bushels without having my trades subjected to the scrutiny of government clerks was to me galling beyond my powers of expression." Ferris, at p. 192. Cutten's victory in the Supreme Court, rejecting the GFA's attempt to bring an after-the-fact criminal prosecution against Cutten for manipulation, *Wallace v. Cutten*, 298 U.S. 229 (1936), spurred Congress to include a strengthened anti-manipulation provision in the Commodity Exchange Act so as to allow prosecutions for manipulation or attempted manipulation even after they have occurred.

unnecessary burden" on interstate commerce and directed the Commodity Exchange Commission to establish such limits on trading "as the commission finds is necessary to diminish, eliminate, or prevent" such burdens:

Sec. 4a. (1) Excessive speculation in any commodity under contracts of sale of such commodity for future delivery made on or subject to the rules of contract markets causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity, is an undue and unnecessary burden on interstate commerce in such commodity. For the purpose of diminishing, eliminating, or preventing such burden, the commission shall, from time to time, after due notice and opportunity for hearing, by order, proclaim and fix such limits on the amount of trading under contracts of sale of such commodity for future delivery on or subject to the rules of any contract market which may be done by any person as the commission finds is necessary to diminish, eliminate, or prevent such burden.[25]

Congress exempted "bona fide hedging transactions" from any such limits. Congress statutorily defined a bona fide hedging transaction as sales or purchases of futures contracts that were offset by purchases or sales of the same cash commodity.[26]

Implementation of 1936 Act

After the passage of the 1936 Act, the Commodity Exchange Commission held hearings and in December 1938 promulgated both position limits and trading limits for grains—at the time the definition of "grain" included wheat, corn, oats, barley, flaxseed, grain sorghums, and rye.[27] The CEC imposed a "position limit" of two million bushels for any single grain futures contract, as well as for "all futures combined" for any one grain. At

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[25] Commodity Exchange Act of 1936, P.L 74-675, 49 Stat. 1491, § 5. For an explanation of the Commodity Exchange Commission , see footnote 12.

[26] Section 4a(3) provided:

> (3) No order issued under paragraph (1) of this section shall apply to transactions which are shown to be bona fide hedging transactions. For the purposes of this paragraph, bona fide hedging transactions shall mean sales of any commodity for future delivery on or subject to the rules of any board of trade to the extent that such sales are offset in quantity by the ownership or purchase of the same cash commodity or, conversely, purchases of any commodity for future delivery on or subject to the rules of any board of trade to the extent that such purchases are offset by sales of the same cash commodity. There shall be included in the amount of any commodity which may be hedged by any person --
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> (A) the amount of such commodity such person is raising, or in good faith intends or expects to raise, within the next twelve months, on land (in the United States or its Territories) which such person owns or leases;
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> (B) an amount of such commodity the sale of which for future delivery would be a reasonable hedge against the products or byproducts of such commodity owned or purchased by such person, or the purchase of which for future delivery would be a reasonable hedge against the sale of any product or byproduct of such commodity by such person.

Id.

[27] 3 Fed. Reg. 3145 (Dec. 24, 1938).

the same time, it imposed a “daily trading limit” of two million bushels on the amount of grain that any person could buy or sell in any one business day.[28]

The CEC established a federal position limit for cotton in August, 1940, and for soybeans in August 1951. The CEC also established limits for fats and oils, including soybean oil, in April 1953, but later suspended the enforcement of those limits and subsequently revoked them in May 1968. The CEC also established speculative limits on lard, onions, eggs, and potatoes.

The establishment of position limits for these commodities under the CEA did not require the CEC to find that an undue burden on interstate commerce had actually occurred in order to establish position limits, and the CEC did not make any such findings as it implemented the statute. Rather, the statute enabled the CEC to establish position limits based upon its reasonable judgment that such limits were necessary to “diminish, eliminate, or prevent” the burdens on interstate commerce resulting from excessive speculation. Accordingly, the CEC imposed position limits on commodities without finding that an undue burden on interstate commerce had actually occurred.

The CEC never established position limits for many of the agricultural commodities subject to its jurisdiction, such as butter, wool, wool tops, livestock, and livestock products. The Chicago Mercantile Exchange (CME) began trading pork belly futures in 1961, live cattle futures in 1964, and live hog futures in 1966. Even before those contracts were added in 1968 to the list of enumerated commodities subject to regulation under the CEA, the CME, acting under its own authority, established speculative limits for trading in those contracts. The existence of these exchange-set speculative limits helps explain why the CEC and the CFTC never set federal speculative limits for trading in livestock futures, and foreshadows a trend toward the use of exchange-set limits that would emerge in the 1980s.[29]

1968 Amendments

The Salad Oil debacle of 1963 exposed ambiguity in the authority of the Commodity Exchange Authority to enforce its position limits.[30] The 1936 provision spoke in terms

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[28] The CEC’s new regulation established higher position limits and trading limits for “spreading in the same grain between markets.” The position limit for spread positions read as follows:

> To the extent that the net position held or controlled by any one person in all futures combined in any one grain or any one contract market is shown to represent spreading in the same grain between markets, the limit on net position in all futures combined set forth in paragraph 1 hereof [relating to position limits] may be exceeded on such contract market, but in no case shall the excess result in a net position of more than 3,000,000 bushels in all futures combined nor more than 2,000,000 bushels in any one future.

The daily trading limit for spread trading was very similar. *Id.*

[29] At the time the CFTC began operating in 1975, “various contract markets [had] voluntarily placed speculative position limits on 23 contracts involving 17 commodities.” 45 Fed. Reg. 79831 (Dec. 2, 1980).

[30] In the Salad Oil scandal, Anthony DeAngelis attempted to corner the soybean market, among other fraudulent activities. At one point, DeAngelis accounted for three quarters of the nation’s exports of soybean and cottonseed oil. As part of his scheme, DeAngelis filled tankers with water and topped off the tanks with soybean and cottonseed oil, falsely representing as collateral for loans that the tankers were filled with vegetable oil. Numerous lawsuits ensued once the fraud was discovered and about 16 firms were bankrupted by the scandal. *The Man Who Fooled Everybody*, Time, June 4, 1965.

of trading, not positions. In 1968, Congress responded by clarifying the law and amending the second and third sentences of Section 4a(1) to clarify the CEA's authority to enforce position limits in addition to daily trading limits.

1974 Amendments

In 1974, Congress overhauled the CEA to remove the regulation of the futures markets from the Department of Agriculture and created the CFTC as an independent regulatory agency. It also expanded the CFTC's regulatory authority to include futures contracts in any commodity, not just the enumerated agricultural commodities. At the same time as it expanded the scope of the CFTC's authority, it reiterated the purpose of the Act to prevent fraud and manipulation and to control speculation:

A fundamental purpose of the Commodity Exchange Act is to insure fair practice and honest dealing on the commodity exchanges and to provide a measure of control over those forms of speculative activity which too often demoralize markets to the injury of producers and consumers and the exchanges themselves.[31]

The addition of many new commodities to the CFTC's jurisdiction presented the new agency with the question of how to determine the speculative position limits for all of these additional commodities. As a first step, it chose to retain the limits for the agricultural commodities that previously had been established by the CEC.[32]

In August 1975, the CFTC initiated an advisory committee program to advise it on how it should perform its duties in view of the recent amendments to the CEA. As part of this advisory program, the CFTC formed an Advisory Committee on the Economic Role of Contract Markets. In 1976, this Committee held eight meetings on its own, as well as several joint public hearings with the CFTC, on the issues of speculative trading, the definition of hedging, and delivery points. The Advisory Committee found that speculative position limits were of limited usefulness, and recommended they be "supplanted by an improved monitoring and surveillance program designed to achieve orderly liquidation of expiring contract months."[33]

In 1977, following its own study of the issue, the CFTC's Office of the Chief Economist (OCE) arrived at different conclusions and recommendations. The OCE study found that, "Other things equal, sufficiently large positions and trades can become a perceptible market factor."[34] It therefore recommended position limits in those markets "where the characteristics of the commodity, its marketing system, and the contract lend themselves to undue influence from large speculative positions," and that the purpose of

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[31] S. Rep. No. 93-1131, 93rd Cong., 2d Sess. (1974).

[32] In 1987, the CFTC imposed position limits for soybean oil and soybean meal contracts at the request of the Chicago Board of Trade.
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[33] *Report of the Commodity Futures Trading Commission Advisory Committee on the Economic Role of Contract Markets*, at 7 (July 17, 1976).

[34] *Speculative Limits*, staff paper prepared by the CFTC Office of Chief Economist, cited at 45 Fed. Reg. 79831, at 79832 (Dec. 2, 1980).

such limits would be to “curtail extraordinary speculative positions which are not offset by comparable commercial positions.”[35]

Exchange-Set Limits

In 1979 the CFTC repealed all daily trading limits, but one year later, in the aftermath of the manipulation of the silver market by the Hunt brothers, it rejected the Advisory Committee’s recommendations that position limits be replaced by a flexible monitoring and surveillance system. In the Notice of Proposed Rulemaking to require exchanges to set position limits for all futures contracts not subject to Commission-imposed limits, the CFTC articulated the need for and purpose of position limits:

Recent activity in the silver markets, however, has caused the Commission to reconsider the intended purpose of speculative limits and the markets in which limits might serve that purpose. In silver, extraordinarily large futures positions were held by a few speculative accounts and may have contributed to the rapid rise and subsequent collapse in the price of that commodity. Further, the concentration of disproportionately large numbers of futures contracts in the hands of one group of speculators was responsible for certain adverse consequences arising from the collapse in the silver market. Had limits on the amount of total open commitments which any trader or group can own or control been in effect, such occurrences may have been prevented.

More generally, the Commission believes that a trader’s net position has a continued effect on price, and if sufficiently large can become a perceptible market factor. In this context, the Commission observes that speculative position limits serve to decrease the potential for positions to influence the general price level. Moreover, by limiting the ability of one person or group of persons to obtain extraordinarily large positions, speculative limits diminish the possibility of accentuating price swings if large positions must be liquidated sharply in the face of adverse price movements or for other reasons.[36]

In promulgating the final rule, the Commission addressed comments submitted in opposition to the rule, including comments raising questions whether the Commission “had demonstrated that speculative limits provided necessary market protection,” “whether such price movements could in any event be prevented by the imposition of such limits,” and whether the proposed rule was appropriate “for markets with broad dependable deliverable supplies and was premised on recent events in the silver market.”[37]

In response, the Commission reiterated the findings in the notice of proposed rulemaking as to the need for position limits:

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[35] *Id.*

[36] 45 Fed. Reg. 79831, at 79833 (Dec. 2, 1980).

[37] 46 Fed. Reg. 50938 (Oct.16, 1981).

As stated in the proposal, the prevention of large and/or abrupt price movements which are attributable to extraordinarily large speculative positions is a Congressionally endorsed regulatory objective of the Commission. Further, it is the Commission's view that this objective is enhanced by speculative position limits since it appears that the capacity of any contract market to absorb the establishment and liquidation of large speculative positions in an orderly manner is related to the relative size of such positions, i.e., the capacity of the market is not unlimited.[38]

The Commission dismissed the general objections regarding the effectiveness and need for position limits:

The Commission believes that the observations concerning the general desirability of limits are contrary to Congressional findings in sections 3 and 4a of the Act and considerable years of Federal and contract market regulatory experience.[39]

In this rulemaking, the Commission adopted Rule 1.61 (now Rule 150.5), which required exchanges to have position limits for all commodities that did not have Commission-set limits.

In 1982, Congress ratified the CFTC's regulatory policy by enacting Section 4a(e), which stated that nothing in the CEA prohibited the exchanges from establishing positions limits themselves, provided that such limits are not higher than any limits the Commission may have established.[40]

Position Accountability

In January 1992, the CFTC approved the CME's request for an exemption from the requirement to establish position limits for all commodities and instead permitted the CME to establish "position accountability" for certain financial contracts traded on the CME.[41] Position accountability permitted exchanges to substitute accountability standards in lieu of position limit rules for both futures and options on futures contracts on three-month Eurodollars and several foreign currencies. The CFTC cited the continued growth in the depth and liquidity of futures and option contracts on foreign currencies and in certain financial futures or options contracts, and noted that this continuing growth had "implications" calling into question the need for position limits, as traditionally structured, in those markets.

Initially, the CFTC stated that the position accountability program would apply to three categories of financial instruments: (1) futures contracts on foreign currencies and

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[38] *Id.*

[39] *Id.*

[40] 7 U.S.C. § 6a(e) (2008). The Commission has continued to apply regulatory requirements and provide guidance for the exchanges on exchange-set position limits. In 1992, the Commission required position limits to be adjusted to reflect increases in the size of a contract's open interest. The 1992 formula has generally been incorporated into the Commission's regulations in 17 C.F.R. 150.5(c) (2009).

[41] *See* 56 Fed. Reg. 51687 (Oct. 15, 1991) (Notice of proposed exchange rule changes; request for comments).

options thereon; (2) futures contracts and options thereon on "certain financial instruments which exhibit the highest degree of liquidity in both the futures and cash markets," and (3) financial instruments "having a highly liquid futures or cash market, but not of the same magnitude as those in the highest class."[42] For futures contracts and options on financial instruments that exhibit the highest degree of liquidity in both the futures and cash markets, and which are readily arbitraged, the CFTC required that any exemption deleting an absolute position limit should include a level that would trigger distinct reporting requirements by a trader at the request of the applicable exchange. And, for contract markets on financial instruments having a highly liquid futures or cash market, but not of the same magnitude as those in the highest class, the CFTC permitted exemptions from the absolute, fixed limit standard on very large speculative positions but stated that the exchanges should include, in addition to the specified reporting requirements, a rule providing for the automatic consent of the trader, when so ordered by the exchange acting in its discretion, not to increase further those positions which exceed the triggering level. Consistent with the CME accountability program, later in 1992, the CFTC approved similar position accountability programs for the Finex Division of the New York Cotton Exchange for its futures and options contract in the U.S. Dollar Index, and Chicago Board of Trade for several of its futures and option contracts on financial instruments.

Six months later, the CFTC determined it would grant additional exemptions from the requirement to establish position limits, in order to permit the use of position accountability for trading in energy commodity contracts.[43] In June 1992, the CFTC stated that exchanges would be permitted to substitute for position limits a position accountability rule meeting specified criteria for the non-spot months of futures and option contracts on certain metals and energy products. The Commission stated it "notes that certain of these metals and energy contracts generally are characterized by a high degree of liquidity, at least equivalent to, and in some cases greater than, certain of the financial futures and options contracts which the Commission would exempt [from the requirement to set position limits]." The standards for this category of exemptions required the exchange to include a reporting requirement at a specified triggering level and the authority to order a trader whose position exceeds the triggering level to halt further increases in the position. The CFTC also stated that, for physical commodities, this exemption from position limits would be appropriate only for the deferred trading months, and spot-month limits would continue to apply.

In 1999, the Commission formally recognized the practice of accountability by promulgating a rule that specifically allowed exchanges to establish position accountability levels, under certain conditions, rather than continue to permit position accountability through the exemptive process. The 1999 rule allowed exchanges to submit a position accountability rule rather than a numerical limit in circumstances in which a contract had been listed for trading for at least 12 months and met certain open interest and volume thresholds.[44] The rule also provided that the exchanges could not use position accountability levels for the spot month; the exchanges were still bound by

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[42] *Id.*
[43] *See* Speculative Position Limits—Exemptions from Commission Rule 1.61, 57 Fed. Reg. 29064 (June 30, 1992).
[44] 17 C.F.R. 150.5(e) (2009).

the regulatory requirement to set numerical spot month position limits at a level no greater than one-quarter of the estimated spot month deliverable supply.

Commodity Futures Modernization Act of 2000 (CFMA)

In the Commodity Futures Modernization Act of 2000 (CFMA), the Congress expressly authorized the use of position accountability as an alternative means to limit speculative positions. Among the "core principles" enacted as part of the CFMA, Designated Core Principle 5 addresses position limitations and accountability: "To reduce the potential threat of market manipulation or congestion, especially during trading in the delivery month, the board of trade shall adopt position limitations or position accountability for speculators, where necessary and appropriate."[45]

Pursuant to the CFMA, the CFTC adopted its Part 38 regulations to apply the new core principle regime to designated contract markets. In Appendix B to its Part 38 regulations, the CFTC provided guidance as to "acceptable practices" for the exchanges to be in compliance with the various core principles. The Part 38, Appendix B guidance for Core Principle 5, "Position Limitations or Accountability," states:

In order to diminish potential problems arising from excessively large speculative positions, and to facilitate orderly liquidation of expiring futures contracts, markets may need to set limits on traders' positions for certain commodities.[46]

The acceptable practices provide that spot-month limits should be adopted for markets based on commodities having more limited deliverable supplies or where otherwise necessary to minimize the susceptibility of the market to manipulation or price distortion. The guidance also allows markets to provide for position accountability rather than position limits "for contracts on financial instruments, intangible commodities, or certain tangible commodities. Markets appropriate for position accountability rules include those with large open-interest, high daily trading volumes and liquid cash markets."[47] The guidance also provides that contract markets could elect not to provide all-months-combined and non-spot individual month limits.[48] In addition, under Part 38, the

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[45] 7 U.S.C. §7(d)(3) (2009).

[46] 17 C.F.R. Part 38, Appendix B (2009).

[47] *Id.*

[48] The Part 38 "Acceptable Practices" for Core Principle 5 states, in part:

> (1) In order to diminish potential problems arising from excessively large speculative positions, and to facilitate orderly liquidation of expiring futures contracts, markets may need to set limits on traders' positions in certain commodities. . . .
> (2) Provisions concerning speculative position limits are set forth in part 150. In general, position limits are not necessary for markets where the threat of excessive speculation or manipulation is nonexistent or low. Thus, contract markets do not need to adopt speculative position limits for futures markets on major foreign currencies, contracts based on certain financial instruments having very liquid and deep underlying cash markets, and contracts specifying cash settlement where the potential for distortion of such price is negligible. . . .
> (3) A contract market may provide for position accountability provisions in lieu of position limits for contracts on financial instruments, intangible commodities, or certain tangible commodities. Markets

existing provisions governing the establishment of exchange-set speculative position limits contained in Rule 150.5 could continue to serve as acceptable practices.

The CFMA also amended Section 3 of the CEA so as to remove the language pertaining to the burdens on interstate commerce that arise from manipulation, excessive speculation and control that originally had been included in 1922 to provide a constitutional grounding for the Act in the commerce clause. The CFMA did not alter, however, the Commission's mandate in Section 4a to establish position limits as it finds are necessary to prevent such undue burdens on interstate commerce. Hence, although the CFMA did not include in the core principles an explicit direction that the exchanges must apply position limits or accountability as necessary to prevent the undue burdens of excessive speculation, at the same time it retained the Commission's explicit responsibility to establish such limits.

The CFTC Reauthorization Act of 2008 contained two provisions regarding speculative limits. It amended CEA Section 4a(e) to give the CFTC enforcement authority over rules certified by exchanges. It also added core principle language regarding position limitations and accountability for derivatives transaction execution facilities.[49]

Bona Fide Hedge Exemption

Since it first directed the Commission to establish position limits in 1936, Congress has made it clear that such position limits should not apply to the legitimate use of the futures markets by commodity producers, merchants, or end-users to price their goods efficiently or to manage their price risks. Section 4a provided a hedge exemption, but narrowly defined bona fide hedging as sales or purchases of futures contracts that were offset by purchases or sales of the same cash commodity.

Legislative and Regulatory Developments: 1956-1974

By the mid-1950s, there was concern that the statutory hedge exemption criteria were too restrictive. In 1956, Congress responded by permitting anticipatory hedging. Congress acted again when in the early 1970s concerns were again raised that speculative limit exemptions continued to be too restrictive. Congress responded to these concerns in the Commodity Futures Trading Act of 1974. First, it expanded the CFTC's exemptive authority by directing the CFTC to treat arbitrage in the same manner as spreads or straddles. Second, because the definition of commodity under the CEA was expanded by the 1974 Act beyond agricultural commodities, Congress

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appropriate for position accountability rules include those with large open interest, high daily trading volumes and liquid cash markets.

(4) Spot-month limits should be adopted for markets based on commodities having more limited deliverable supplies or where otherwise necessary to minimize the susceptibility of the market to manipulation or price distortions. The level of the spot limit for physical-delivery markets should be based upon an analysis of deliverable supplies and the history of spot-month liquidations. Spot-month limits for physical-delivery markets are appropriately set at no more than 25 percent of the estimated deliverable supply. . . . Markets may elect not to provide all months-combined and non-spot month limits.

17 C.F.R. Part 38, Appendix B.

[49] *See* 7 U.S.C. §2(h)(7) (2009).

was concerned that statutory definition failed to take into account the risk-shifting needs that were emerging at that time. Accordingly, Section 4a(3) was repealed, and the CFTC was given broad administrative authority to define the type of activity that constituted bona fide hedging, subject only to the conditions that any such definition be "consistent with the purposes of the Act" and that "such terms may be defined to permit producers, purchasers, sellers, middlemen, and users of a commodity or a product derived therefrom to hedge their legitimate anticipated business needs . . . ."[50]

In 1977, following up on the recommendations of the Advisory Committee on the Economic Role of Contract Markets, the CFTC fashioned a definition of hedging and a process for granting hedge exemptions that remains in place today. This definition is found in Rule 1.3(z) of the Commission's regulations.[51]

Futures Trading Act of 1986

By the early-1980s, however, new questions concerning the CFTC's hedge exemption standards emerged. As Congress considered what eventually became the Futures Trading Act of 1986, the House Agriculture Committee urged the CFTC to consider expanding the hedge exemption to include financial firms using the futures markets to manage various types of financial risks.[52] The report of the Senate Committee on Agriculture, Nutrition and Forestry noted the then-current definition of a bona fide hedge transaction "may not cover certain important new uses of financial futures and options

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[50] 7 U.S.C. §4a(c) (2009).

[51] This rule contains three parts. First is a general description of transactions or positions which the Commission considers to be bona fide hedging under economically appropriate circumstances, and specifies that no transaction or position shall be classified as bona fide hedging for purposes of exceeding federal speculative limits unless, among other requirements, it can be established and liquidated in an orderly manner. The first part states that an entity may hedge inventory or fixed price sales or purchases without prior approval of the Commission, but must file monthly reports with the agency for positions in excess of the position limits.

The second part, "Enumerated Hedging Transactions," specifies one of the two other types of transactions that may qualify for the exemption, but that require prior Commission approval. Section 1.3(z)(2) states that a bona fide hedge exemption may be granted for purchases or sales for future delivery of unsold anticipated production or unfilled anticipated requirements. The various types of such anticipatory hedges are "enumerated" in this subsection.

The third part of the definition—the "non-enumerated" cases—provides that for purposes of exemptions from federal speculative limits the Commission may recognize as bona fide hedging purchases or sales other than those enumerated in the second part of the definition. This is intended to avoid the very type of inflexibility that Congress sought to avoid by deleting CEA §4a(3) and giving the Commission regulatory authority. It requires persons requesting permission to classify transactions as hedging to provide the Commission with evidence that such transactions meet the requirements of the general definition in Regulation 1.3(z)(1) and permits the Commission to specify any conditions it deems necessary to assure the positions are consistent with orderly markets and other requirements of the CEA.

17 C.F.R. §1.3(z) (2009).

[52] H. Rept. 624, 99th Cong., 2d. Sess., at 45-6 (1986).

by institutional investors." The report urged the Commission to review its practices to ensure they were "consistent with the legitimate needs and practices of the industry."[53] The Committee determined, however, that statutory changes were not necessary:

The Committee agrees that the Act provides the Commission with the power to make any needed revisions in the hedging definition and that no statutory changes are needed for this purpose. The only limit section 4a(3) places [on] the Commission's power to define hedging is that the definition must be consistent with the purposes of the Act. In this context, a principal purpose of the Act, as set forth in section 4a(1), is that of preventing excessive speculation which causes sudden or unreasonable fluctuations or unwarranted changes in commodity prices. Within this broad parameter, the Commission clearly has the necessary power, as well as the responsibility, to define hedging in a way that is consistent with the current needs and practices of the industry.[54]

Although the Committees urged Congress to review the definition of a bona fide hedge transaction, Congress chose not to amend the statute, instead leaving the CFTC with discretion to determine the contours of the bona fide hedge exemption.

There have been no further changes to the statutory provisions regarding bona fide hedging. Although the Commission has issued a number of interpretations to its regulatory definition, and has proposed a new risk management exemption on several occasions, these interpretations and proposals have not been directed by the Congress, but rather have occurred as a result of the Commission's application of the statute.

Application of Bona Fide Hedge Exemption to Risk Management Activities

In 1987, the CFTC issued a statement clarifying its interpretation of its bona fide hedging rule. The CFTC stated that various users and potential users of financial futures had expressed concern that the link to transactions in the physical commodity markets is overly restrictive and precludes the classification as hedging of numerous strategies that are otherwise risk reducing.[55] The CFTC explained that the definition should not be construed to apply only to firms using futures contracts to reduce their exposure to risks in the cash market. It stated that the Commission's original intent in promulgating the definition of a bona fide hedge was to provide a general definition to describe the broad scope of risk-shifting transactions that may be possible in the diverse types of futures contracts now under regulation. The CFTC concluded that to qualify as a bona fide hedge, a transaction in the futures market did not need to be a temporary substitute for a later transaction in the cash market, but also included all balance sheet and other trading strategies that are risk reducing and otherwise consistent with this interpretation.

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[53] S. Rept. 291, 99th Cong., 2d. Sess., at 21-2 (1986).

[54] *Id.*, at p. 22.

[55] *See* Clarification of Certain Aspects of the Hedging Definition, 52 Fed. Reg. 27195 (July 20, 1987).

Several months later, the CFTC issued a new interpretation of its definition of bona fide hedge transactions to permit exchanges to grant hedge exemptions for various risk management transactions. The CFTC stated that the exemption of certain risk-management positions from exchange speculative limits would be consistent with the objectives of the hedge exemption. The CFTC explained that it adopted this broader view of the hedge exemption so that any futures or option positions involved in such risk reducing strategies currently would be eligible for exemption from exchange speculative limits pursuant to exchange rules. The CFTC specified that such exemptions be granted on a case-by-case basis, subject to a demonstrated request and showing by the applicant of the need for the exemption. The CFTC also required that applicants for such risk management exemptions be typically engaged in buying, selling or holding cash market instruments. Additionally, the CFTC required the exchanges to monitor the exemptions it granted to ensure that any positions held under the exemption did not result in any large futures or options position that could disrupt the relevant futures market.[56]

In accordance with the 1987 clarification and the following interpretation, in 1991 the Commission staff granted a bona fide hedge exemption to a swap dealer who was seeking to manage price risk on its books as a result of swaps it planned to enter into with various investors seeking exposure to commodity indexes. Similar hedge exemptions were subsequently granted in other cases where the futures positions offset risks related to swaps or similar OTC positions involving both individual commodities and commodity indexes. These exemptions have been subject to specific conditions to protect the market, including: (1) the futures positions must offset specific price risk; (2) the dollar value of the futures positions must be no greater than the dollar value of the underlying risk; and (3) the futures positions must not be carried into the spot month.

Although the CFTC staff has granted several hedge exemptions to a number of swap dealers for their commodity index-related swaps, it has determined that it was not appropriate to grant such exemptions to exchange traded funds (ETFs) for their investments in futures contracts to ensure that the net asset value of the fund tracked the commodity index upon which the fund was based. On two occasions, however, the CFTC staff determined it was appropriate to provide no-action relief from the position limits for agricultural commodities to the managers of index-based funds. In 2006, the CFTC staff issued a letter stating that it would not enforce the position limits with respect to Deutsche Bank's operation of a commodity-related ETF.[57] Later that year it provided similar relief to another firm.[58]

The topic of hedge exemptions continues to be a major topic of interest to the CFTC. In November 2007, the CFTC proposed to amend its regulations to create a new type of

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[56] *See* Risk Management Exemptions From Speculative Position Limits Approved Under Commission Regulation 1.61, 52 Fed. Reg. 34633 (Sept. 14, 1987).

[57] CFTC Letter 06-09 (May 5, 2006).

[58] CFTC Letter 06-19 (Sept. 6, 2006).

exemption from the standard position limits.[59] Called a "risk management exemption," it would permit ETF managers to apply for permission to exceed established position limits, rather than have to continue to rely upon no-action letters. The CFTC noted that the last substantive changes to its position limits had been made in 1991, and the intervening 16 years have seen significant changes in trading patterns and practices in derivatives markets. The proposed risk management exemption would have allowed an exemption from position limits for: (1) intermediaries, such as index funds, who pass price risks on to their customers; and (2) pension funds and other institutional investors seeking to diversify risks in portfolios by including an allocation to commodity exposure. This proposed rulemaking was withdrawn in 2008.[60]

In September 2008, the CFTC released a Staff Report on Commodity Swap Dealers and Index Traders with Commission Recommendations, which included several preliminary recommendations. One such recommendation directed CFTC staff to develop an advance notice of proposed rulemaking to review whether to eliminate the bona fide hedge exemption for swap dealers and replace it with a limited risk management exemption that is conditioned upon, among other things, an obligation to report to the CFTC and applicable self-regulatory organizations when certain noncommercial swap clients reach a certain position level and/or a certification that none of a swap dealer's noncommercial swap clients exceed specified position limits in related exchange-regulated commodities. In March 2009, the CFTC published a concept release on whether to eliminate the bona fide hedge exemption for certain swap dealers and create a new limited risk management exemption from position limits.[61]

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[59] 72 Fed. Reg. 66097 (Nov. 27, 2007).

[60] 73 Fed. Reg. 32260 (June 6, 2008).

[61] 74 Fed. Reg. 12282 (March 24, 2009).