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Chicago Board of Trade

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OFFICE OF THE SECRETARIAT

Ms. Jean A. Webb
Secretary of the Commission
U.S. Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

COMMENT

COMMODITY FUTURES TRADING COMMISSION RECEIVED FOR PUBLIC RECORD SEP 16 1 55 PM '98

Re: Speculative Position Limits

Dear Ms. Webb:

The Chicago Board of Trade ("CBOT" or "Exchange") respectfully submits this letter in response to the Commodity Future Trading Commission's ("Commission") July 17, 1998 Federal Register Release that requests comment regarding the Commission's revisions to the federal speculative position limits and associated rules.

I. Introduction.

The CBOT generally supports the direction of the Commission's reproposed revisions to the federal speculative position limits and the proposed amendments to the associated rules. However, the CBOT would prefer that the Commission grant the exchanges sole responsibility to establish and monitor speculative limits subject to Commission oversight. As previously submitted in our June 10, 1992 comment letter response to the Commission's original release entitled "Revision of Federal Speculative Position Limits", the CBOT believes that granting us sole responsibility to establish and monitor speculative position limits in all of our markets would result in limits which better reflect and are more responsive to the dynamics of the markets. Nevertheless, the CBOT commends the Commission for finally reproposing to increase the levels of agricultural speculative limits.

The CBOT opposes the CFTC proposal to codify a requirement that the spot month limit level for newly designated physical delivery contracts must be no greater than 25% of the estimated spot month deliverable supply calculated separately for each month to be listed.

II. Reproposal to raise the levels of speculative position limits for the deferred months to the levels originally proposed.

The CBOT recommends that the Commission adopt its originally proposed levels of Federal speculative position limits. The CBOT agrees that a review of open

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interest and trader position data indicates that open interest has continued to grow since the implementation of the phase 2 limits.

Furthermore, the CBOT believes that open interest for its Oat futures and futures options contracts has also continued to grow in a manner that justifies raising position limits to the levels originally proposed.[1]

The CBOT also reproposes that the Commission modify its spread exemptions to include spreads between single months across crop years. The CBOT is disappointed that the Commission's July 17, 1998 release fails to raise the concept. The concept of granting spread exemptions for positions across crop years was presented in detail by the CBOT in its April 28, 1995 comment letter response to the Commission's April 7, 1993 release entitled "Revision of Federal Speculative Position Limits; Reopening of Comment Period." The Commission has had approximately three and one half years to consider and review the likely effect of modifying the spread exemptions to allow old crop/new crop spreads.

In the Exchange's April 28, 1995 comment letter, we submitted that by normalizing inter-crop spread limits with the limits presently permitted for intra-crop spreads, non-commercial traders would be in a position to provide greater market liquidity in deferred new crops and eliminate a possible cause for the reduced market liquidity that occurs near the end of a crop year. In addition, the Exchange commented that by modifying the spread exemptions to encompass inter-crop spreads, the Commission would foster increased liquidity which would in turn benefit producers seeking to manage their risk. Specifically, the Exchange noted that:

> As the level of government price supports continues to be reduced in response to reductions in global trade restrictions, producers and consumers of agricultural commodities will have a greater incentive to substitute market-based risk management tools for government price supports. For grain producers, their risk is greatest during the spring and early summer months of [the] crop development period. Since this risk affects the value of the crop to be harvested 4 - 6 months later, prudent risk management strategies necessitate the use of new crop contracts at a time when the bulk of trading and open interest is in the nearby old crop months.

Although the CBOT recognizes that the Commission has, in the past, granted "no action" status regarding its speculative limits prohibition on inter-crop spreads, more recently, the Commission has refrained from granting "no actions" generally.

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1 The Commission's Speculative Position Limits Table within the Federal Register Release incorrectly indicates that the current level (as of March 31, 1994) for the CBOT's Oat futures contract spot month is 400. In fact, the current level for the Oat contract spot month is 600. The CFTC correctly indicates the level for the CBOT's Oat futures contract spot month within its proposed rule 150.2 at the end of the release.

In any regard, as noted by the CBOT in its April 28, 1995 comment letter response, the "no action" process as applied to spread positions is "cumbersome, unnecessary and causes confusion and uncertainty for market participants." The Exchange noted further that such "no actions" are necessarily reactive and therefore ineffective because they are initiated only after the spreads have experienced significant price movement.

III. Proposal to codify the various policies relating to the requirement that exchanges set speculative limits as required by rule 1.61. (Exemption permitting exchanges to substitute position accountability rules for position limits for high volume and liquid markets.)

The CBOT feels that the existing process for administering position accountability has served the industry well and, as a result, the CBOT questions the need to codify the process. We believe that more flexibility is afforded the Commission through the current process which allows the Commission to rely on the liquidity of the underlying cash market and the opportunity for arbitrage. In particular, the Exchange is concerned that its 30 Day Fed Funds contract which presently receives position accountability status (based in large part on the liquidity of the underlying cash market) will no longer qualify if the proposed rules are codified.

IV. Proposal to amend the applicability of the limited exemption from non-spot month speculative position limits under Commission rule 150.3, for entities that authorize independent account controllers to trade on their behalf.

The CBOT is supportive of and encourages measures that have the potential to increase liquidity and thereby enhance the price discovery and risk management function of our markets.

V. Proposal to amend the Commission's rule 150.4 on aggregation, to require a limited partner, shareholder, or other type of pool participant (such as a member of a limited liability company), to aggregate the pool's position with the trader's other positions if the trader has an ownership interest of 25% or greater in the pooled account or if the pool has ten or fewer participants.

In its release, the Commission indicates that it has become aware of, and concerned about, trading by single-investor commodity pools whereby a single limited partner may contribute virtually all of the pool's trading capital, relying upon the general partner to control the trading in the account. The Commission's specific stated concern is that the limited partners in question may be less than wholly passive investors. The Commission indicates that it believes that "the likelihood that the limited partners may be involved to some degree in the trading decisions of the partnership's trading activity rises as the overall number of limited partners in a commodity pool decreases, such as in single or limited-number investor pool or when a small number of limited partners have a relatively

dominant ownership interest." 63 FR 38525, at 38532 (July 17, 1998).

From a regulatory perspective, the CBOT shares the same concerns as the CFTC, especially with respect to monitoring expiring contracts. However, with this said, the CBOT has not experienced any "disorderly" liquidations of its expiring contracts as a direct result of trading by such entities.

Notwithstanding our regulatory view, the CBOT is concerned that the proposed aggregation requirement could have a negative impact on the liquidity of our contracts. In this respect, the CBOT believes that the CFTC should consider performing a trading impact study that analyzes the effect that the proposed aggregation requirement would have on market liquidity. It may be that the CFTC's concerns with respect to the potential for participation by limited partners, and the like, are outweighed by the need to promote active and liquid markets, especially in the delivery month. The CBOT will be interested in reading the comment letter responses filed on behalf of the entities and individuals who would be effected by the proposed aggregation requirement.

VI. The Commission proposal to codify a standard for determining the spot month limit level for newly designated physical delivery contracts. (Proposed speculative limits rule 150.5.)

Specifically, the CFTC is proposing to codify a requirement that "the spot month limit level for physical delivery contracts must be no greater than one-quarter of the estimated spot month deliverable supply calculated separately for each month to be listed and for cash-settled contracts based on a small or not highly liquid underlying cash market must be at a level that will tend to prevent or diminish price manipulation." (See, proposed rule 150.5(b)(1).)

Disturbingly, neither of the Commission's Federal Releases that refer to the proposed formula for spot month speculative limit levels indicate nor do they discuss the Commission's methodology for determining the proposed formula. Instead, the Commission's formula is simply proposed without any underlying justification.

In the past, the CBOT, as well as numerous industry participants and renowned agricultural academics, have questioned and criticized the Commission when it has attempted to impose its "rule-of-thumb" formula.[2] Most recently, the Commission relied on its "rule-of-thumb" formula in determining whether to approve the CBOT's revisions to the delivery specifications of our Corn and Soybean contracts.

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[2](See, the numerous comment letters filed by the agricultural industry during the review process of the CBOT's revisions to the delivery terms of our Corn and Soybean futures contracts.)

Apparently, the proposed formula was derived through a process of reverse engineering that has no sound basis in economics. The formula was "backed-into" as a result of a simple analysis that approximated the historical levels of deliverable supply during inverted markets. In short, the Commission's staff analysis demonstrated a positive relationship between price inverses and deliverable supplies of less than 12 million bushels. Since spot month speculative limit levels are 600 contracts or 3 million bushels, the Commission's staff apparently simply divided 3 million by 12 million which resulted in 25%.

However, as the CBOT and others have noted to the Commission, inverses are natural economic events and, as such, should not be viewed negatively. For instance, the study prepared by University of Illinois Professors Thompson, Irwin and Good, which was previously provided to the Commission, states:

> It is economically rational and to be expected that deliverable supplies would be low during periods of inversions since deliverable supplies would be expected to reflect the overall tightness in stocks which generated the price inversion. Inversions discourage stock holding. The fact that inversions are associated with relatively large long positions is also not surprising, since it is during periods of inversions that long commercial hedgers, such a processors, most need price protection in anticipation of near-term cash purchases.[3]

In addition, the Commission was recently provided the study prepared by Dr. Craig Pirrong which, in relevant part, reads that:

> Insofar as the relation between inverses and stocks are concerned, an extensive empirical and theoretical literature demonstrates that inverses *should* exist in competitive, unmanipulated futures markets when stocks are low. Working (1948), Bresnahan and Spiller (1986), Williams and Wright (1991), Pirrong (1997c) are representative of this literature.
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> Indeed, a lack of inverses and persistently high stock levels is more symptomatic of a dysfunctional market than periodic episodes of inverses and low stocks. Moreover, the occurrence of an inverse when stocks are large is more indicative of an expiration problem than the existence of an inverse when stocks are low. Working (193_).
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> The CFTC also provides no evidence that the other symptoms of manipulation—specifically, sharp rises in stocks during the delivery period followed by large out-shipments following contract expiration, and sharp declines in the cash price in the delivery market both absolutely and relative to prices in other markets following liquidation of large long positions were

[3]Dr. Darrel Good, Dr. Sarahelen Thompson, Dr. T.A. Hieronymous and Dr. Robert Hauser, Department of Agricultural and Consumer Economics, University of Illinois at Urbana-Champaign, Northern Illinois Waterway Delivery for Corn and Soybean Futures – A Perspective (June 1997).

present during the periods in which inverses occurred. Thus, there is no basis to conclude that the observed inverses-stocks relation indicates frequent expiration problems. The evidence provided is consistent with a competitively functioning delivery process.[4]

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[4]Dr. Pirrong continues to state that:

> One could interpret the CFTC position to mean that any market which exhibits periodic inverses is unduly susceptible to market manipulation, and that the Commission favors an expansion of delivery capacity sufficient to make inverses unlikely. The elimination, or near elimination, of inverses would impair the price discovery performance of the soybean futures contract. In particular, the contract could not provide an effective mechanism for pricing crop year transitions.
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> The reported relation between position size and inverses is hardly convincing either. For one thing, the categorical comparison employed is very crude. A more complete and convincing analysis would determine whether the relation between position size and inverses persist when more discriminating techniques, such as a regression analysis, in which position size enters as a continuous variable (perhaps interacted with stock levels) and which controls for other factors that could influence spreads. Earlier work suggests that the connection between position sizes and deliverable stocks may not be as clearcut as the Commission avers. Peck and Williams (1992, pp. 168-170) use regression analysis to examine the relation between changes in price spreads over the delivery month and the size of the four largest futures positions relative to deliverable supplies over the 1982-1989 period. They find no association between position concentration in the expiring soybean future and a decline in soybean spreads during the delivery month, except for September contracts. Such a relation would be expected if concentration contributed to expiration problems during the sample period. Peck-Williams find a concentration-spread change relation for corn and wheat. They also find that on average spreads narrowed during the delivery month for soybeans, corn, and wheat. Interestingly, this decline was more pronounced during the period Toledo was a delivery point for all three contracts.
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> For another, even if one concedes a correlation between position size and inverses, it is far more problematic to conclude that there is a causal relationship. Any long manipulator must have a position substantially larger than the quantity that can be delivered to him at competitive prices; a manipulator profits by taking excessive deliveries (which is costly) in order to drive up the price at which he liquidates the remainder of his futures position. That is, the manipulator loses money on the deliveries he takes, but makes money by selling futures contracts at a supercompetitive price. Profitable manipulation therefore requires that the long's position exceed by a substantial margin the quantity available for delivery at competitive prices. Thus, if 10 million bushels are available for delivery at competitive prices, a long may need a 15 million or 20 million bushel position (if not larger) to manipulate profitably. The CFTC analysis of position sizes and inverses reports that inverses are common for soybeans when stocks are less than 12 million bushels and the largest long has more than 3 million bushels. It is clearly impossible for a trader long 3 million bushels to corner a contract with 12 million bushels available for delivery. The exercise of market power would be problematic even if the largest position were considerably larger than 3 million bushels when stocks were smaller than 12 million bushels. Thus, although the inverse-position size relation the CFTC relies upon so heavily in its analysis could indicate chronic expiration problems, the connection is far, far from proven.

In sum, the premise of limiting speculative position limits to some percentage of deliverable supplies is arbitrary and flawed as a matter of economics. The proposed formula implies that there should be fewer speculative positions in times of tight supplies, and more speculative positions at times of large supplies. However, it is typically during times of tight supplies that more hedging activity tends to take place and when prices are generally more volatile. By reducing the amount of speculative positions allowed, during these times, to take the opposite sides of hedge positions, price volatility is likely to increase due to lower liquidity in the market. That volatility would result from an artificially-created condition, not from market conditions, and would have the negative results of reducing the hedging effectiveness of the futures contract and forcing market users to resort to exempt off-exchange risk management instruments.

Furthermore, the Commission's proposal to determine different spot month speculative limit levels for each of the months (based on the estimated deliverable supply for that particular contract month) will be extremely confusing and cumbersome to the marketplace.

The CBOT respectfully submits that prior to codifying its "rule-of-thumb" standard for determining speculative limits for the respective delivery months, the Commission should include in a release for public comment a substantive description of the methodology it used to establish the basis for its proposed formula. Specifically, the release should describe, in detail, how the Commission determined that 25% of deliverable supply constitutes the appropriate number for speculative limit levels in the delivery month. In addition, the CBOT believes that such a release should discuss: how deliverable supply is measured; who determines deliverable supply; what constitutes deliverable supply; and, when deliverable supply should be measured for the purpose of the formula.[5]

Manipulation is even less likely if four traders hold the maximum speculative position. If these speculators do not collude, competition between them leads to a smaller price distortion than would occur if a single long held a 12 million bushel position. Thus, if a single long requires a 15 million or 20 million bushel position to manipulate a market profitably, four longs holding 12 million bushels or eight longs holding 16 million bushels could not profitably manipulate the market.

[5]While the Commission may have attempted to provide a definitive description of deliverable supply within its companion Federal Register Release entitled, "Economic and Public Interest Requirements for Contract Market Designation", the definition is far from conclusive. The definition reads that deliverable supply "represents product which is in store at the delivery point(s) specified in the futures contract or economically can be moved into or through such points within a short period of time after a request for delivery and which is available for sale on a spot basis within the marketing channels that normally are tributary to the delivery point(s)." 63 FR 38537, at 38539 (July 17, 1998). Although, at first, it may appear that the Commission has provided a quantitative definition of deliverable supply, further scrutiny reveals that the Commission has, in fact, provided a definition that is both subjective and

VII. Conclusion.

The CBOT requests that the Commission grant the Exchange sole responsibility to establish and monitor speculative limits subject to Commission oversight. We believe that such a policy would result in limits which better reflect and are more responsive to the dynamics of the markets.

Nevertheless, the CBOT is supportive of the Commission's proposed revisions to the federal speculative position limits and associated rules with the exception of the Commission's attempt to codify its "rule-of-thumb" formula for determining spot month speculative limit levels for new contracts. The CBOT respectfully submits that the Commission's proposed formula is arbitrary and economically flawed, a view supported by well regarded academics and numerous industry participants in prior comment letter responses filed with the Commission.

Accordingly, prior to codifying its controversial formula, the CBOT recommends that the CFTC issue a separate release devoted to the fundamental questions of what constitutes "deliverable supply" and why speculative spot month limits should represent no more than 25% of "deliverable supply". Such a release would provide the interested members of the industry and the public the opportunity to substantively comment regarding these important issues.[6]

Respectfully submitted,

Thomas R. Donovan

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economically flawed. The requirement that deliverable supply must be within the marketing channels that normally are tributary to the delivery point(s) is troublesome. Such a definition would prohibit grain from flowing into the delivery system (despite the fact that such movement was economically justified) based on an arbitrary and subjective determination that the grain was supposed to flow elsewhere. For example, despite the fact that the CBOT (in support of its proposal modify the delivery terms of our Corn and Soybean futures contracts) provided reliable data that established nearby and readily available stocks and inventories of corn and soybeans available for delivery against the contracts, the CFTC arbitrarily excluded such grain on the unjustified basis that the movement of such grain into the CBOT's delivery system would constitute "abnormal flow".

[6]Until a rational methodology, based on sound economic principles, is codified for determining both the level of deliverable supply available to a physical delivery futures contract and the level of deliverable supply necessary for a futures contract to perform efficiently, the CFTC will be free to arbitrarily dictate the terms of futures contracts as it did in the context of its review of the revisions to the delivery specifications of our Corn and Soybean futures contracts.