

Closing the Swaps Loophole

Proposal #1

June 18, 2008

Background: In 1936, Congress authorized speculative limits on individual investors to restrict the amount of futures contracts they could hold in any one commodity. These individual limits play an important role in preventing market manipulation and can help curb food and energy price inflation. The speculative position limits only apply to financial investors, not to bona fide hedgers such as a farmer who may trade futures contracts – contracts to buy or sell a crop at a future point at a price set today – in order to reduce financial risk.

Congress originally imposed individual speculative limits to address market manipulation and excessive speculation. But due to the recent influx of large investors, such as pension funds and other large institutional investors - and the rise in speculative activity – some observers believe that the limits no longer serve their original purpose. The Commodity Futures Trading Commission (CFTC) does not use the limits as a regulatory tool for addressing the aggregate effect of excessive speculation and, with few exceptions, has generally delegated that authority for setting the limits to the for-profit futures exchanges. For certain commodities, such as oil and natural gas, the limits have been replaced with “position accountability levels,” which impose reporting requirements on large speculators.

Under the “swaps loophole,” financial institutions that buy and sell futures contracts on the futures exchanges are treated as bona fide hedgers, even if the only purpose of their futures trading is to hedge the financial risk they acquired by acting as a swaps dealer in the over-the-counter markets. For example, a bank may enter into an over-the-counter commodity swap agreement with a financial investor in which it agrees to provide a financial return based on the price appreciation of a commodity index, in exchange for a fixed payment from the investor. The position limits do not apply to over-the-counter trading in commodities, which has experienced dramatic growth in recent years.

Proposal: Some experts have proposed closing the Swaps Loophole to ensure that individual speculative position limits serve their original purpose to reduce excessive speculation and prevent price manipulation. The proposal would:

- Require the CFTC to replace “position accountability levels” with individual speculative position limits that it sets, rather than the exchanges. It would clarify that position limits should be set at no greater level than necessary to ensure sufficient market liquidity for the conduct of bona fide hedging activities.
- Clarify that the individual speculative position limits shall apply to any position not related to bona fide hedging activities. This will eliminate the exemptions from the position limits that currently apply to swaps dealers and other financial institutions.
- Extend speculative position limits to commodities holdings held by financial investors, whether those positions are held on a U.S. futures exchange, a foreign futures exchange, or in the over-the-counter markets. The CFTC would be directed to develop a methodology that would allow investors to aggregate positions held on the futures exchanges and in over-the-counter contracts for purposes of regulatory enforcement of the position limits.