Speculative Position Limits*

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*Comments on earlier drafts of this paper by Richard G. Heifner and Bruce Wright are appreciated.
I was asked to review the speculative limit provisions of the 1936 Commodity Exchange Act including the historical debates, as well as give my own views. Since giving my views nearly five years ago,\(^1\) futures trading has burgeoned and I appreciate the opportunity to revisit the subject.

A difficulty with position limits as a topic is that it spreads over many other topics. In particular, one cannot judge the wisdom of any speculative limit on a commodity futures without first exploring whether a change in contract terms might do more good. Appraisal of contract terms is one of the most difficult of exercises. The Commodity Futures Trading Commission Act is now a compelling force in this direction.

I will begin with a short perspective on contract terms and then examine position limits, taking up the 1936 act and the debates; the views of a high-level CFTC Advisory Committee; and then my views. I will conclude with some general comments. The opinions expressed here, of course, are my own and are not necessarily those of the USDA.

I. Toward contract improvement

History teaches that futures contract terms for a commodity invariably get out of line with fundamental conditions in production and trade. But selection of better contract terms requires detailed trade knowledge, analytical skill, and luck. While this responsibility belongs with the exchanges, an exchange, being an organization of diverse interests, may not always be able to make needed changes. So what happens is either that changes are not made and conditions continue to deteriorate, or the government is petitioned by segments of the trade that are not represented by the exchange to legislate specific changes, or to press the exchanges to revise their contracts.

The use of federal legislation to change the New York cotton futures contract is a classic example of government making improvements that the exchange itself was unable to make. This is what the 1916 Cotton Futures Act—reinstating “commercial differences”—and 1927 and 1928 cotton legislation—instating southern delivery—were all about.

With the enactment of the Commodity Futures Trading Commission Act of 1974, the government has final responsibility for approving contract terms and can require exchanges to revise existing terms to prevent or lessen manipulation, congestion, or abnormal commodity movement. A basic dilemma continues. The intricate nature of commodity markets suggest that the exchanges are well equipped to design futures contracts. Presumably, the commercial members find it in their self-interest to develop terms suitable for business uses. However, the speculative members are primarily interested in trading volume and price action. There is no assurance that this combination of member motivations will result in contract terms that are in the best public interest. Yet, exchanges innovate. Left to their own devices, they sometimes try way-out things, like attempting to trade in live cattle and live hogs. One wonders, in view of the strong opposition of packer and producer groups in 1964, whether the exchange would have been granted a license under today’s federal authority. History shows the wisdom of allowing exchanges full scope

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to innovate even though more new contracts fail than succeed. But history also teaches that exchanges sometimes are incapable of making badly needed changes—changes which would lessen recurring squeezes and price distortions. Hopefully, the 1974 law will turn out to be a workable compromise to get improved contracts without, at the same time, discouraging innovation.

II. The Commodity Exchange Act

Turning now to the main subject. The Grain Futures Act of 1922 was elaborated into the Commodity Exchange Act of 1936 to include other commodities beside grains and directed the Commodity Exchange Commission to limit the size of speculative positions if it found this necessary to “diminish, eliminate, or prevent unreasonable fluctuations or unwarranted changes in the price of commodities.” Speculative positions were defined as all positions that are not bona fide hedges as defined in the act.

The act allowed the Commission to set the same or different limits for different commodities, markets, and delivery months. In practice, the Commission has used mostly flat and permanent limits. Spread positions were treated as if each leg were a speculative position. For semiperishables like potatoes, flat, permanent, but lower limits were set for contracts maturing late in the marketing year.

At present only about one fourth of the actively traded commodities have federal position limits (Table 1). Inclusion of monetary instruments would lower this figure to about one fifth. About as many commodities have exchange limits as CFTC limits. Thus, one half have some kind of limits and one half do not. Federal limits are now the same for all futures combined in a contract as they are for any one future. The only significant changes in such limits, since their inception, have been the raising, in recent years, of the 2 million bushel speculative limit on corn, wheat, and soybeans to 3 million bushels and, postwar, the lowering of the cotton limit from 30,000 bales in one future to 30,000 bales in all futures combined.

Table 1. Federal limits on positions, net short or net long

<table>
<thead>
<tr>
<th>Commodity</th>
<th>Limits in any one future on any one contract market</th>
<th>Limits on all futures combined on any one contract market</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corn, wheat, and soybeans</td>
<td>3,000,000 bushels</td>
<td>3,000,000 bushels</td>
</tr>
<tr>
<td>Oats, barley, and flaxseed</td>
<td>2,000,000 bushels</td>
<td>2,000,000 bushels</td>
</tr>
<tr>
<td>Rye</td>
<td>500,000 bushels</td>
<td>500,000 bushels</td>
</tr>
<tr>
<td>Cotton</td>
<td>30,000 bales</td>
<td>30,000 bales</td>
</tr>
<tr>
<td>Eggs, shell</td>
<td>150 carlots</td>
<td>150 carlots</td>
</tr>
<tr>
<td>Potatoes, March, April, and May</td>
<td>150 carlots</td>
<td>150 carlots</td>
</tr>
<tr>
<td>Futures</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other futures</td>
<td>300 carlots</td>
<td>350 carlots</td>
</tr>
</tbody>
</table>

a For barley, 3,000,000 if 1,000,000 bushels or more of the total represent spreading in the same grain between markets.

b Does not apply to spread positions, except during a delivery month.

Source: CFTC

* The 1936 coverage included cotton, rice, millfeeds, butter, eggs, and Irish potatoes, as well as wheat, corn, oats, barley, rye, flaxseed, and grain sorghums. Wool tops were added in 1938 and fats and oils, cottonseed meal, cottonseed, peanuts, and soybean meal were added in 1940. Wool was added in 1954 and onions in 1955 (Donald Campbell, “Trading in Futures under the Commodity Exchange Act,” The George Washington Law Review, vol. 26, no. 2, January 1957).
The CFTC also imposes daily trading limits of equal size to position limits. Evidently, the purpose is to enable every position to be liquidated in one day, if need be.

The definition of “bona fide hedging” is a critical matter. Over time, it became evident that the legal definition, whose language essentially followed popular economic doctrines about hedging and speculation, restricted business uses. The growth in size of firms and changes in business practices increasingly tested the wisdom of long-standing hedging criteria.

The first liberalization of the definition was the 1956 amendment allowing “anticipatory hedging” by manufacturers and processors who wished to fix the price of raw materials for the next 12 months. This amendment exceeded in liberality a modest proposal that was dismissed in 1936—namely, that only firms that had a demonstrable equivalent of a fixed price commitment to sell output, e.g., branded and heavily advertised products, or catalogue offerings, etc.—be allowed to fix the price of their raw materials. Also, the anticipatory hedging exemption enabled soybean processors to put on a “paper crush” in large volume because there were no position limits on meal, and those on oil were removed earlier.

In 1969, cattle feeders and other producers of livestock and poultry were exempted from limits on futures positions in corn (and other feed) taken to cover needs. In 1973, hybrid seed corn firms were allowed to classify as hedges the purchases of corn futures in anticipation of later fixing the price to hybrid seed growers. But these hedges were allowed only on a bushel-for-bushel basis. In 1975, an interim change in definition of hedging was effected by a provision of the 1974 act to permit bakers to hedge unfilled flour needs in wheat futures; users of dry corn milling products and sweet corn processors to do the same in corn; and seed corn processors to hedge the “bushel value equivalent” of their unfilled annual requirements in corn futures and not just the actual number of bushels to be processed. Also, this permitted, for the first time, the classifications of short positions in soybean oil and meal futures as hedges against cash soybeans.

Continually redefining hedging in the law came to an end with the passage of the 1974 act, placing the entire authority for these definitions with the CFTC.

The arguments for and against speculative position limits go back many years and I have not had time to do more than sample the various debates. Herbert Hoover, Food Administrator during World War I, testified that power to limit the size of speculative trades would be given to a board, making the implementation of limits flexible. He thought that, once established, it may never be necessary to exercise such power. 

But a provision authorizing speculative limits was stricken from the 1921 Senate bill and from the conference report, with the observation that reasonable limitations upon transactions would vary from season to season and

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3 House Agriculture Committee Hearings, 66th Congress, 3rd Session, January 18, 1921, pp. 900, 902.
from year to year. Thus, a fear of limits was that the control agency would not use them in a flexible way.

In a 1928 hearing, a spokesman for cotton shippers allowed that members of his association had manipulated cotton prices and so favored adding southern delivery to the New York contract. He also favored position limits periodically reset to the size of crop and seasonal supply.

I think it should be a flexible limitation. I might make that 250,000 bales for a big crop in the heavy-moving season and that should be scaled down to much less during the summer months, when there is not much cotton pressing the market.

He favored leaving it up to the Commission to have absolute jurisdiction and control over these matters. A contrary view was expressed by Representative Rankin who observed that, "I am in favor of writing the law into the law, so people of the country will know what it is today and what it will be next month."6

The idea of imposing a flat 2 million bushel limit on major grains apparently grew out of investigation by the Grain Futures Administration of the unsettled wheat and corn markets of the 1920's. These studies purported to show that speculative trades that exceeded 2 million bushels moved prices unduly. One quote from 1930 testimony will suffice.

We have found many cases where extensive trading for speculative purposes on the part of a few individuals generally moved prices in line with their trading. . . . An extensive study covering a period of two years, from January 1925 to December 1926, for example, we found in over 80 percent of the cases, where an individual trader bought or sold as much as 2,000,000 bushels in a single day, that the price moved in the same directions as the trading, that is, advanced on purchases and declined on sales.

Opposition to the 2 million bushel limit was voiced by various industry representatives on the grounds that it would be too rigid. Thus, a flour milling company representative observed in a 1932 hearing that there might be times when it would be possible to manipulate the market with individual lines of less than 2 million bushels. There might be times when 3 or 5 million bushels might not be too much.

In 1934 hearings, the chief of the Grain Futures Administration objected to proposed margin controls over speculation because it would limit only those without the financial means to meet them; he said position limits would operate

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4 Congressional Record, 67th Congress, 1st Session, August 23, 1921.
5 Hearings, on Supervision of Cotton Futures Exchanges, U.S. Senate, April 10 and 13, 1928, p. 17.
6 Ibid.
7 House Agriculture Committee Hearings, on H.R. 11952, 70th Congress, 1st Session, pp. 22-23.
more certainly and more equitably. In the 1936 hearings, he said that he would not object to a 20 percent margin requirement on lines above 2 million bushels as an additional or perhaps alternative provision in the bill. The novel idea of coupling increased margin requirements to increased size of position will be surfaced in later discussion.

III. CFTC advisory committee viewpoints

In August 1975, the CFTC established four advisory committees of distinguished people, largely from trade and academic callings, to consider and make recommendations on a wide range of topics. One committee considered, among other things, criteria to be used by the Commission in establishing position limits. Its report, issued in July 1976, reached the following conclusions.

The idea of controlling speculators as though they were less important or more dangerous than hedges is basically unsound. Speculative position limits, by their nature, point the finger of suspicion at speculators. In fact, however, five of the eight market manipulation cases brought under the Commodity Exchange Act between 1972 and 1975 were against commercial operators with hedging exemptions for at least a major part of their trading.

Very few speculators operate on a large scale, compared to either the current Federal speculative position limits or to the size of hedging operations. In the commodities where speculative position limits are currently in effect, few speculators, on the average, have holdings near the limit. In the commodities where there are no speculative position limits, natural market dynamics also seem to hold down the size of speculative positions.

Since speculators do not normally operate on a relatively large scale, and since speculative position limits do not effectively limit the abusive market power of the large commercial firms, speculative position limits do not provide a very strong defense against market abuses. Such limits may actually reduce competition in the futures market and work to the advantage of the large operators.

In the delivery month, where the problems of congestion and manipulation usually become evident, speculative position limits are not a useful means of assuring orderly liquidation. A flat limit that is not overly restrictive in nondelivery months is "no limit" during the delivery month. Speculative position limits may have some minor effect on congestion by preventing some speculators from accumulating very large positions that would aggravate liquidation difficulties in the delivery month.

Speculative position limits would have almost no utility at all for many of the newly regulated commodities. Those with a dependably broad supply (no seasonal factors, no storage problems, easy transportability), and those which may be arbitrated from highly liquid markets in other countries, would derive even less benefit than speculative position limits usually.

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\(^{6}\) *House Agriculture Committee Hearings, 73rd Congress, 2nd Session, April 17, 1934*, pp. 209-12.

\(^{10}\) *Hearings* on Jones bill that was enacted into the Commodity Exchange Act, U.S. Senate, 74th Congress, 1936.
provide. In those commodities which are also traded on liquid futures markets overseas, such limits would be ineffective at best and at worst could drive trading away from the U.S. exchanges.\textsuperscript{11}

Up to this point, the committee appeared to be speaking as one, but strong disagreements occurred over the final conclusion, which stated:

The Advisory Committee is agreed that speculative position limits are not a very powerful tool for the CFTC in its futures market regulatory role, nor can they be made to be. They provide little regulatory help for the majority of commodities regulated by CFTC. Even for those commodities where the strongest case can be made for speculative position limits, they provide almost no help in the crucial delivery months.

The Advisory Committee concluded that, because of their inherent shortcomings, speculative position limits should be supplanted by a comprehensive effort to provide a more flexible CFTC monitoring and surveillance program.\textsuperscript{12}

Two knowledgeable members, Professor Hendrik Houthakker and Paul McGuire, former chairman of the Chicago Board of Trade, joined in this dissent:

We are not convinced that speculative position limits are either useless or harmful to legitimate trading. Suitably designed speculative limits can prevent concentration of market power, one of the principal causes of unsatisfactory performance of futures markets.

The main problem with existing speculative limits is that they are too low for present levels of open interest, although even so they do not appear to have been a serious constraint. The limits should be set annually for each contract market at (say) 10 percent of a 5-year average of maximum open interest, though never less than (say) 50 or 100 contracts.

We are correspondingly opposed to watering down the hedging concept. In particular, we strongly oppose the notion that all operations undertaken by commercial interests should be considered hedging. Apart from strictly defined hedging, in which there is an offsetting position in the cash or forward market, we would admit certain types of anticipatory and cross-commodity hedging, but only on the basis of general rules rather than individual application. There may also be a need for special rules on maximum positions in expiring futures contracts.\textsuperscript{13}

Why did the minority think that there may be a need for special rules on maximum positions in expiring futures contracts? The reasons are not in the committee report, but some were given in committee hearings.


\textsuperscript{12} Ibid.

\textsuperscript{13} Ibid.
Every case of manipulation has to do with people who have tried to convert futures into cash contracts, who are unwilling to roll their hedges forward, who are unwilling to make reasonable trade-offs against cash, who hold their futures position as a pawn to force someone to either cover the futures or deliver the cash.

If the size of positions that carried into the delivery month is unwieldy, sometimes the problem can’t be solved and leads to such things as forced liquidations, telephone calls at seven o’clock in the morning to suspend trading, or to force some particular kind of percentage liquidation.

A final point. The Committee said that “few speculators, on the average, have holdings near the limit” is evidence of the ineffectiveness of such limits. But this begs the question whether big speculative positions are taken under the guise of hedging. Also, with the benefit of hindsight from the 1979-1980 silver episode, one should reexamine the degree of validity in the Committee’s view that, “In the commodities where there are not speculative position limits, natural market dynamics seem to hold down the size of speculative positions. . . . Those with a dependable supply (no seasonal factors, no storage problems, easy transportability) . . . would derive even less benefit than speculative limits usually provide.” Evidence for this view was presented, showing that for six months in 1975, in none of the markets studied, including silver, did positions classified as speculative dominate the larger size classes. This proposition would not hold were a survey taken for positions during 1979 when the Hunts and others had large speculative positions. Nor would it likely hold if a survey were taken of late 1973 and early 1974, when the Hunts also had large positions.

IV. My Viewpoints

In mid-1973, I was asked by the administrator of the Commodity Exchange Authority to make a study of the definition of hedging for purposes of exemption from speculative limits. This was part of a general government reexamination of futures trading and the need for new legislation. I filed a preliminary report in early 1974 suggesting, among other things, that the act should not attempt to define specific types of transactions that constitute bona fide hedging because there are too many cases to be covered; that, because it is extremely difficult to draw an unambiguous line between hedging and speculation, the issue should be avoided insofar as possible by setting liberal position limits; but where hedging must be defined to accommodate larger business uses of futures, adhere to strict economic criteria; and that, in any case, bona fide hedging should not be completely exempt from position limits during the delivery month. These ideas were elaborated in a full report submitted to the newly appointed commissioners of the CFTC and, subsequently, issued as USDA Technical Bulletin 1538.

The amendment of the Commodity Exchange Act in late 1974, known as the Commodity Futures Trading Commission Act, ceded to the CFTC full authority to define hedging. But whether it contains the authority for the CFTC to impose position limits on hedge transactions during the delivery

14 Ibid.
15 *Hearings, Commodity Futures Trading Commission Act*, U.S. Senate, Committee on Agriculture and Forestry, 93rd Congress, 2nd Session, Part 2, May 1974, pp. 480-82.
month, except under its emergency powers, is another matter.
Notwithstanding, the amendment was a big step because it gave the control agency a great deal of flexibility in how tightly the exemption could be drawn.

The following are my views as modified by lessons from recent futures trading experience. For purposes of clarity, the term *speculative position limits* will be used in the usual sense. The term *comprehensive position limits* will refer to limits placed on all futures commitments irrespective of the way they are classified, and the term *position limits* will refer to either or both types of limits as suggested by the context in which it appears.

For convenience, most pricing problems in futures markets may be divided into five types, although, in practice, they may interact or overlap.

1. **Squeezes and corners.** All commodity futures contracts have a squeeze potential because there are positive costs of making and taking delivery. These costs may or may not present serious problems, depending on the nature of the commodity stored and on the availability of stocks, storage, and transport services in relation to the number of contracts outstanding. Large delivery costs tend to create a large squeeze potential. Such costs should be examined closely to see how they might be reduced. At the extreme, a long squeeze results in a corner of the shorts by one or more longs who control, or are allied with those who control, much of the deliverable supply. The shorts must settle at prices largely dictated by the longs, or else default.

2. **Manipulation of the closing price on any given day, either up or down.**

3. **Day trading by exchange members that accentuates daily price fluctuations.**

4. **Trading by anyone beyond one day that contributes to nonrandom price behavior.**

5. **Price stabilization or price raising by those who control much of the cash commodity.** This could lead to periodic squeezes or corners but its primary intent is longer-run gains.

Now to elaborate. Squeezes and corners are delivery month phenomena. Aside from improvements in contract design, or moral suasion, comprehensive position limits are the most promising instrument of control. Ideally, such limits should be graduated in line with the deliverable supply of the commodity. The possibilities for doing this depend on how well such supplies can be estimated in advance. Yet, for some commodities, enforcement of flat speculative position limits, under a narrow definition of hedging, probably would go a long way in preventing squeezes and corners. This will be suggested by a fairly recent potatoes episode.

Manipulation of the closing price is a momentary pricing aberration that cannot be corrected until the next session. It is more likely to occur in periods when a market is thinly traded than at other times. There may be various defenses against such trading abuses but position limits are not among them.

Day trading that accentuates price fluctuations within the day, where it occurs, is primarily the result of actions for the trader’s own account. There is nothing
that position limits can do to alter this when it occurs because such traders tend
to even up toward the end of the session. One would have to consider the
advisability of limiting daily trader volume in some way, including the
disadvantages.

Positions held over a longer period are another matter. One basic problem is
that many people believe that if prices have been rising, they most likely will
continue to rise (and vice versa). The ease with which one can enter into futures
trading exaggerates the tendency for market psychology to cause cycles in price
movements. Thus, a reason for imposing speculative position limits is that the
combined action of big traders tends to move prices in one direction (usually
upward) which lures more small traders into the market, who then sustain the
price trend, thus providing large traders an opportunity to offset at a profit.
Another reason is that big traders, including professionally managed trading
pools, may tend to follow a common trading plan based on behavior of prices
rather than on fundamentals. Another reason is that, in any case, when big
traders are wrong, they shock prices unnecessarily. The degree of validity in
these and other arguments only can be tested against empirical observation.
Studies of randomness of futures price movements show mixed results as
Tomek has reported. Departures from random movements apparently have not
been large, raising a question whether there is a serious issue here.

There is another way to prevent undue influence of large traders on price,
namely, place constraints on the amount by which the individual net
speculative positions can change from one day to the next while allowing large
positions to exist. This idea was briefly mentioned in CFTC Advisory
Committee discussions. I believe this rule would lock big traders into their
positions for more days than now, thereby dampening their inclination to
assume larger positions than are warranted by fundamentals. But it would
require prudent setting of margin requirements as positions became larger in
order to safeguard the integrity of the contracts.

Price stabilization and price raising by those who control a large share of the
cash commodity have recently come into evidence in commodity futures
markets, raising some fundamental questions about public policy. Obviously,
speculative position limits could be an effective instrument of constraining such
uses of futures trading, except when it is so used by the U.S. government for
commodity price policy as in 1930-1931 by the Federal Farm Board.

Turning now to recent commodity experience that illustrates different facets of
position limits as a control instrument. The May 1976 large potato default was
most unfortunate. From what I can deduce, it seemed preventable.
Historically, a loose interpretation must have been given to bona fide hedging
so that the 150 contract limitation, net short or net long on speculative
positions, in May futures was not binding on any positions taken by commercial
potato interests who were considered to be hedgers. Otherwise, how does one
explain the following:

On the last trading day . . . one individual raised his “long” position by about
2,500 contracts to a total of over 4,000 contracts. Other traders who
apparently had heard rumors of the large acquisition of long contracts also
acquired long contracts in order to take advantage of the situation. The
deliverable supply of Maine potatoes—the only potatoes which could be
delivered in satisfaction of the contract—was inadequate to cover the open positions, and the "shorts" were unable to deliver. The long position holders had cornered the market.\textsuperscript{16}

Besides questioning the appropriateness of such long positions under the 150 contract rule for maximum speculative positions, I would also question whether the large short positions held by two western potato people should have been treated as hedges. There is not a good correlation between the prices for russets in the West and round whites in New York City. This is a general difficulty with the legal definition of hedging in the 1936 Act. It begs the question of what is "the same cash commodity."

The closing of potato trading in March 1979 was a different matter. Over 80 percent of the potatoes tendered by the shorts failed inspection, reflecting the poor keeping quality of Maine potatoes—pointing to the need to do something about contract terms, shipping-point specifications, and the possibilities of arranging an equitable system of cash settlements.\textsuperscript{17}

The March 1979 wheat episode growing out of a shortage of deliverable supplies illustrates another facet of position limits. The interesting matter here is not so much the classification of positions, as the uselessness of permanent position limits in lowering potential manipulative power.

This episode was studied by Richard Heifner for the House Agricultural Committee. After reviewing the various emergency actions that might be taken when orderly liquidation of positions is not forthcoming, he concluded that

Halting trading is an extremely powerful emergency tool for the CFTC, but one that is fraught with dangers. It can impose great inconvenience and unexpected losses upon the innocent as well as the guilty. It introduces difficult problems of determining fair settlements and tends, over the long run, to undermine confidence in and usefulness of the market. Consequently, less drastic measures which prevent traders from acquiring or holding manipulative positions during the delivery period are to be preferred. In particular, regularly prescribed position limits which force traders to reduce their large positions as the contract matures are recommended.\textsuperscript{18}

He said that the appropriate size of delivery period position limits for each maturity would be determined through experience and suggested starting the last week of trading with no more than one third of the estimated deliverable stocks in any account—a rule that would have imposed an 800,000 bushel limit on each trader on March 15, 1979, in place of the current 3 million bushel limit. In each prior week of the delivery month, the permissible limit would be stepped up.


\textsuperscript{17} See Allen B. Paul, Kandice H. Kahl, and William G. Tomek, Performance of Futures Markets: The Case of Potatoes, USDA (forthcoming bulletin).

While Heifner would apply such graduated limits during the delivery month to both hedgers and speculators alike, he did not say whether the existing speculative limits governing prior months should be altered.

Coffee and silver futures illustrate still other aspects of the role of position limits. Both commodities were brought under jurisdiction of the CFTC in 1974 but neither had any speculative limits, and neither have now. The result in coffee, in recent years, has been the use of the futures market by an organization of coffee producing countries to stabilize the price. Is the “gamesmanship” that is introduced into the market by the manipulative group good for the long run health of futures trading? The flavor of the times is further suggested by this clipping from Barron’s:

Last Wednesday, just as the Coffee, Sugar, and Cocoa Exchange was moving to head off a possible squeeze in the December contract, one reportedly engineered by the “Bogota Group” of Central and South American growing states, a group of African producers were meeting in Abidjan, on the Ivory Coast. Among the delegates there was reportedly intense curiosity about market manipulation. At least, one dispatch had it, the African states—known collectively as the Interafrican Coffee Organization—were weighing the formation of a united front to operate in futures markets.19

The issue then is this: how far can we count on speculation in futures markets that have no position limits really being self-limiting?

The silver experience provides some additional insights. Silver does not appear to be a squeezable commodity because, as a store of value, there are idle stocks that could be made available to cover current shortages for industrial uses. In the 1974 words of an informed observer:

...Classically, if you have a squeeze situation...you have what we call backwardation in the market. You have premiums on the nearby positions, and with the spot position way up in the air. Now, every silver contract, with the exception, I think, of one of very brief flurry in February, every silver contract has been liquidated at a discount, and very often severe discounts, which quite conclusively demonstrates that there has been no scarcity of the commodity for delivery. You have extreme premiums forward. They are so big that they provide carrying charges. So I suggest that the price of silver reflects a good deal more than Hunts’ willingness to carry more than $40 million.20

This view looks like it ought to have held during the 1979 accumulations of silver claims by the Hunts (and others), and it probably did. I examined six expiring futures contracts in 1979 and they do not show backwardation. No price for a futures was above the price for a succeeding futures. But this surely is too loose a criterion to apply.

19 Barron’s, November 26, 1979, pp. 63-64.
A stricter criterion would only require that the price of each futures be below the price of the next futures by the cost of holding—which is primarily interest. When interest rates are high, the price for the expiring futures can be appreciably out of line with the price of other futures months without rising above any of them. I do not know whether this happened.

However, the major lesson is something else. In an era of inflation, futures trading in silver (and perhaps other precious metals) can serve as an engine of credit that generates too large and rapid a rise in the price of silver. Heavy purchases of silver in any form that drives up the price, creates profits that in the case of futures can be readily withdrawn to buy more cash silver, which again drives the price up, again creating more withdrawable profits in futures, and so on. An unfortunate thing is that this price action lures many others into buying silver, thus, feeding the upward movement in prices until the entire structure of commitments is tested by credit withdrawals.

With this recital of recent experiences, my view of position limits can be restated succinctly. Apart from commodities that should have effective speculative position limits to forestall the use of futures for price stabilization or price raising, I would confine position limits largely to pricing problems in the delivery month. There are three general principles to guide regulation, namely:

1. Raise speculative limits on all positions that are held before the delivery month. These settings will require study of the need for orderly liquidation of large positions before the delivery month arrives in order to get down to a reasonable threshold level at the start of the delivery month, as well as other factors. Also, consider replacing such speculative position limits with limits on the daily change in net speculative positions, and with margin requirements geared to the size of each trader’s net position to safeguard the contract.

2. Restrict hedging exemptions to futures positions that meet strict economic criteria, as revealed by historical correspondence of cash and futures price movements, and monitor these exemptions closely.

3. For futures contracts that are subject to recurrent squeezes, place comprehensive position limits on all traders during the delivery month, using graduated limits that, in some sense, are geared to estimates of deliverable supplies.

I do not think that these ideas are exactly novel. They appear consonant with the minority views of the CFTC Advisory Committee. But they are different from conditions obtaining today.

V. Concluding observations

I wish to conclude with an historical perspective on ultimate causes of increased public control over futures trading. Each of the three major pieces of legislation yielding control over futures trading to the government was a quantum step. Curiously, all three seem to have resulted in large measure from something the governments rather than business did or should have done.

To elaborate, the 1921 (and 1922) Grain Futures Act, which brought futures trading in grain under federal licensing and monitoring, grew out of a great war and its aftermath. For three years, there was no open market in wheat futures.
The subsequent rise of wheat and other grain prices, as a result of urgent postwar demands of European governments, followed by a collapse of prices, brought on a congressional investigation in 1921 and passage of the Grain Futures Act. It was then observed by the Board of Directors of the CBOT, on their acknowledgment of certain deficiencies in futures trading, that

speculation on exchanges generally was not more excessive than speculation in commodities not traded in on exchanges, but the public mind was inflamed and misinformed because of the general policy of the public press to write up in spectacular manner the operation of individuals in the market. . . .

Secondly, the 1936 Commodity Exchange Act, which authorized speculative limits and brought additional commodities under its jurisdiction, was a culmination of many years of dissatisfaction with prices—especially dissatisfaction among farmers. Yet, at bottom, the passage of the act probably grew out of general financial collapse of the 1930's and the quest to put all the institutions of trade and finance on a more secure footing. The 1936 act was but one of a family of laws enacted to correct unsound practice and prevent abuses on banking, insurance, stock issue, etc.

The circumstance leading to the 1974 act, which brought all futures trading under federal license and greatly extended federal powers should be clear in our memory. But it is easy to get lost in proximate causes and fail to see the inescorable monetary expansion between 1969 and 1972 that underlay subsequent commodity price movements. Worldwide forces of inflation were loose and they sustained much of the unprecedented price rises of individual commodities that were responses to particular supply or demand situations.

To quote Professor Robert Triffin:

World import and export prices, measured in dollars, rose by less than one percent a year in the 1960's, but by more than six percent a year from 1970 through 1972, and by as much as 30 percent a year in the last 12 months before the explosion of oil prices in the fall of 1973. This was not unconnected, to say the least, with the enormous and mounting U.S. deficits abroad which flooded the world monetary system, doubling world reserves from the end of 1969 to the end of 1972 . . . increasing them by as much in this short span of three years as in all previous centuries in recorded history. . .

In sum, my thesis is that enactment of successively greater governmental controls over futures trading has largely been a result of what governments previously have done or have not done in a much larger domain. On the other hand, it is only fair to say that much of the growth of futures trading since 1974 has been a result of the same governmental actions described above.

The great expansion in futures trading in commodities, debt instruments, and precious metals is a consequence of the general instability of prices.

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21 Senate Hearings. Futures Trading in Grain, May 27, 1921, p. 475.

The period since 1972 has revealed even greater credit expansion. As long as this course continues, individual commodity markets are likely to attract, from time to time, the play of large speculative forces. More people eschew fixed money claims and seek to build their capital with claims on commodities as well as other holdings. If futures trading is to be allowed to function effectively in such an unstable economic world, we will need to muster whatever improvements in the machinery and the regulation of trading that reason tells us are in the public interest. It will make large demands on our insight and understanding which, hopefully, we can further develop by continued study and discussion.
Todd Petzel: Allen, you mentioned the 1920's wheat studies. We've redone those and we didn't find any evidence at all of large speculators having a price effect on the long term or causing excessive fluctuations. This keeps coming up all the time. Have there been any government studies since that time that have looked at the role of large speculators in any price episodes?

Allen Paul: I'm sure that Congress has called for some studies made for particular situations, but right now I can't identify them. The study that Richard Heifner and others made of the large export sales of grain wasn't quite along this line, but it did ask whether they positioned themselves in the futures market to their own benefit with advance information. A study of large speculators should be done eventually to try to understand what trading rules are being used by people who have money at their disposal to put into markets. This is possible now that we have computers and sharp trading by very competent fundamental analysts. If you could isolate the position of people who control large funds and look at prices at that time, this would be possible but would have to be done in conjunction with CFTC data.

Don Bidgood: You said you'd propose liberalizing the limits on noncurrent months. Would you consider the elimination of the total net position limit?

Allen Paul: I would consider it, but I think there's a problem. If you're going to have in some commodities comprehensive position limits on hedgers as well as speculators because of recurrent squeezes, you may well have to have a graduated set of limits in the previous month or two to see that they get down there. In other words, there may be some problem of liquidating to a threshold limit. With silver, I would say no because the problem is quite different. That is not a delivery month problem as I see it, but a problem of an engine of credit, and there's a place where position limits would do some good.

Don Bidgood: In your paper you call for serious consideration of replacing such limits with limits on the daily change in net speculative position. I think you are referring to the fact that right now, although we have a spec limit, it applies during the day too. Are you saying here that the spec limit would apply only at the close of business in each day and allow traders to exceed that spec limit during the day?

Allen Paul: Well, the spec limit now is a spec trading limit, that is, a volume limit. We're talking about positions.

Don Bidgood: The current CFTC regulation says there is a 3 million limit on beans. That applies during the session too.

Allen Paul: Can that be monitored?

Don Bidgood: Yes, it can be.

Allen Paul: Well, I didn't know that and have not given it any thought.
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