Position limits are a key issue in the reform of the commodity derivative markets as part of the review of the Markets in Financial Instruments Directive (MiFID). There is now broad consensus that the levels of financial speculation in the commodity derivative markets seen in recent years can have a distorting impact on prices in the physical markets. Improved transparency and regulation, including position limits, are needed to prevent market manipulation and excessive financial speculation from contributing to volatility and price spikes.

**Position limits**
Position limits cap the number of contracts in a particular commodity that can be held by a trader or group of traders, preventing concentration by the individual or group concerned. This ensures traders do not ‘corner’ markets or exert an excessive influence on prices.

Position limits require oversight and intervention by supervisors. If the trader or traders concerned reach their position limit, supervisors would intervene to require them to reduce their positions until they fell below the limit.

Position limits have a number of advantages:

**Effectiveness**
Position limits were used to effectively regulate the commodity derivative markets in the US for most of the twentieth century. Their removal in the 1990s coincided with the start of the growth in excessive financial speculation. Financial speculation in the commodity markets also has an impact on businesses in Europe with farmers and other users reporting increased difficulties being able to use commodity derivatives markets to hedge price risk and predict prices. As European producers become increasingly reliant on financial markets to manage their risk with the reform of the Common Agricultural Policy, it is vital that they serve their intended purposes and are not distorted by excessive speculation or market manipulation.

“Over 150 years of futures trading history demonstrates that position limits are necessary in commodities of finite supply to curb excessive speculation and hoarding.”
Ann Berg, former commodity trader and Chicago Board of Trade director, adviser to the UN Food and Agriculture Organization

**Consistency**
Position limits are being reintroduced in the US to tackle excessive speculation. Failure to implement similar provisions in the EU would risk international regulatory arbitrage. Position limits are the norm for regulating the commodity markets, and are used in Japan, Hong Kong, Singapore, China, Australia and South Africa.

**Legal certainty**
Position limits give traders certainty as to what trades they can and cannot carry out.

**Transparency**
Position limits can be published to ensure that traders know how all markets participants will be treated and avoid perceptions of discrimination.

**Adaptability**
Far from being inflexible tools, position limits could be introduced gradually and reviewed regularly to ensure their effectiveness whilst maintaining sufficient liquidity. They can also be adapted for different markets and types of participant. Authorities in EU member states will retain the right to use additional and, if necessary, tougher, controls than these limits if they find it appropriate.

**Freeing up much-needed capital for investment in the productive economy**
Speculation in the commodity markets is not investment – none of the money is invested in improving production. An additional benefit of introducing position limits could be the freeing up of much-needed capital for investment in the productive economy, rather than it continuing to be gambled on financial markets.

Food price volatility causes problems and costs for consumers, producers and businesses in Europe. In developing countries, where households typically spend 50 to 90 per cent of their income on food, food price spikes can have devastating impacts.

Position limits are the norm for regulating commodity markets around the world, and must be a central feature of EU regulation. An approach which relies solely on position management, without limits, has failed in the past and must not be taken.
Position management

Position management does not involve the setting of clear limits on traders’ positions. Instead it gives trading venues or another body authority to request an explanation or reduction of a trader’s position if it is deemed necessary. There are a number of risks/drawbacks of a system that relies solely on position management:

Lack of effectiveness
Position management is the UK’s existing approach to regulating commodity markets, and has failed to prevent even blatant incidents of market manipulation. For example, in July 2010 the hedge fund Armajaro nearly cornered the entire European cocoa market through the London-based exchange, pushing prices to a 33 year high. This prompted a group of European industry figures to warn that they would move their business to the US without better controls to prevent such abuses. In May 2011 Frontier Agriculture, one of the UK’s major grain marketing businesses, bought all the feed wheat futures contracts available on the London exchange, effectively buying up the whole market. Had position limits been in place, these incidents would not have been possible.

Conflict of interest
Position management tends to be left to trading venues to implement, as in the UK currently. As trading venues profit according to the volume of trading they handle, they have a significant disincentive to act to reduce a trader’s position.

Failure to prevent problems
Position management only tackles problems once they arise, often after there have been harmful impacts, rather than preventing them occurring in the first place.

Lack of transparency and legal certainty
Traders cannot know when position management might be deemed necessary or exercised, or be sure that their competitors will be treated in the same way, risking perceptions of discrimination.

Uneven playing field
Without an EU-wide provision for position limits (not just position management), some member states or trading venues may seek to gain unfair advantage through adopting a less stringent approach.

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More detailed information on this topic, including a referenced version of this briefing, is available at www.wdm.org.uk/food

Rain not a flood: how much liquidity do markets need?

Liquidity refers to the ease with which a trader can enter and exit a market, which depends on number of trading opportunities in a market at any one time. A certain level of liquidity is necessary in the commodity derivative markets to ensure that there is always someone willing to take the other side of a contract that commercial traders set up to hedge their risk.

However, the markets are now experiencing levels of liquidity far beyond what is necessary to facilitate commercial hedging. Efforts to standardise derivative contracts in order to bring their trading on to regulated trading venues such as exchanges as part of the current regulatory reforms is likely to increase liquidity further. Levels of financial speculation could therefore be reduced considerably without having a negative impact on liquidity. Data from the US markets in the 1990s suggests that commodity markets worked effectively for hedgers, without a lack of liquidity and with relatively stable prices. At this time, as little as 25 to 30 per cent of the market was held by financial speculators – compared to well over half currently being experienced in some markets.

Recommendations

Given the devastating impact of food price spikes on the world’s poorest people, as well as negative impacts for businesses and consumers in Europe, it is vital that the review of MiFID delivers measures to effectively curb financial speculation on food prices to prevent it contributing to food price spikes.

Specifically, decision makers must ensure that the new legislation:

• Delivers real time position reporting of all traders’ positions, in commodity derivatives in a comprehensive and standardised format, with aggregated data made public on a daily basis.

• Ensures aggregation of this data across all trading venues and OTC to determine each traders’ total positions and how much of the market is speculation.

• Provides sufficient powers and capacity for ESMA to set, monitor and enforce individual and category position limits to prevent excessive speculation and market manipulation in all markets.

• Does not contain loopholes, such as unnecessarily wide exemptions or the current provision for trading venues to apply position limits “or alternative arrangements...such as position management” which fails to ensure that position limits are used consistently across the EU.