

POSITION LIMITS: SIGNIFICANCE IN THE PRESENT DAY FINANCIAL EXCHANGES

Equity and Commodity futures markets today are highly susceptible to market manipulation and the growing need for regulations against them is commonly debated phenomena in current news circles. This is especially true in the current fall of the KSE and generally applies to exchanges worldwide. We in Pakistan, have yet to be able to efficiently grip this problem and overcome it. It can be independently done at an exchange level provided there are factors present such as political independence, institutional richness etc. Manipulation is commonly condemned since it comes in way of two primary functions of futures markets that is the facilitation of efficient transfer of risk from the hedgers to the speculators and to convey reliable and worthy information about demand and supply conditions of the market. Henceforth, manipulation causes extreme volatility in the depiction of futures prices, reducing the rationale behind their movement. Price movements caused by manipulations do not reflect changes in underlying demand and supply fundamentals, thus reducing the efficiency of futures markets which are supposed to be models of risk transfer and price discovery mechanisms.

As per the Commodity Exchange Act (CEA) of 1936 amended, manipulation is an offense punishable by large fines and imprisonment. The current regulator of futures markets in the US, the Commodity Futures Trading Commission (CFTC), can impose civil damages upon firms registered with the Commission if they manipulate the market. Moreover, the CFTC limits the size of futures positions that speculators can hold.¹

Regulatory bodies thus focus greatly on anti manipulation regulations and means and methods of surveillance and monitoring any forms of manipulation on a continuous basis. For this purpose, preventive and risk aversive measures such as position limits, exemptions, margining, and aggregation are used.

POSITION LIMITS

Position limits are defined as the maximum number of contracts that a participant may hold. The purpose of these limits is to prevent speculators from exercising undue influence on the market. **The Chicago Board Options Exchange** often specifies a position limit for option contracts which an investor can hold on one side of the market. These limits are further bifurcated into speculative position limits and hedge exemptions. The speculators/investors are subject to the speculative position limits. Hedgers can obtain exemptions from the limits if they demonstrate that larger positions are necessary to implement a bona fide hedge, which the concerned exchange may deny or revoke at any time if they detect the position to be speculative rather than the claimed hedge.

The basic purpose of imposing a position limit is thus very clear; when a participant, member or a client, takes up huge positions in the futures markets, their market power to

¹ www.cftc.gov

manipulate the price movements and other factors increases with their size. Hence, imposing a restriction on the positions held would constrain their ability to capture and manipulate the market while exercising their market power. This makes way of the market to populate more traders, insuring more efficiency and authenticity in the market movements. Even though it is argued that speculators with large open interests are the most efficient bearers of risk and the most well informed about the demand and supply fundamentals, excessive speculation in a commodity or equity traded for future delivery causes abrupt and unaccountable fluctuations in its price. Thus it becomes vital to curb these manipulations through position limits, which acts as a cap on the amount of speculative trading and positions held for that purpose in commodity and equity futures. Position limits are imposed at a Client/Customer level, at a Trading Member level, and at a Market wide level.

Standards to set the limits are determined by the exchange keeping in mind various factors. For example in a commodity like Gold, the exchange needs to determine the total volume of gold, which will account for the size of the cash/spot market. Based on that and the number of estimated traders, the exchange imposes a percentage of the total market which each broker can hold at a broker or member level, and a separate percentage which can be held at an individual client level. Violating these exchange set limits, calls for disciplinary action, as instituted by the exchange.

In commodity markets where physical delivery is involved, speculative limits are set at a lower level in the spot month, where the futures contract matures and is available for delivery. In the spot month, the contract may become more vulnerable to price fluctuations caused by large positions and other manipulative practices. Therefore keeping in mind the deliverable supplies and the past spot month liquidation trends, spot month limits must be lower and not more than say, 5% of the deliverable supply, or so set by the exchange. This limit being lower than normal is necessary to minimize the potential manipulation and distortion of the contract or the commodity's price. In most cases as practiced by exchanges normally, reducing the position limits in the spot month is balanced by the levying of delivery margins, which in turn mitigates the risk of any large position that may be carried by any trader. Henceforth rules of margining along with speculative position limits, helps to curb manipulation to a large extent.

As mentioned earlier, exemptions are granted by the regulators and exchanges from these position limits for the purposes of "*Bona Fide hedging*". Traders hedge with futures when they want to reduce the price risk. The futures hedge effectively locks in a futures price so that hedgers will not lose from an adverse price change or profit from a favorable price change. Thus, a futures hedge eliminates both, the downside risk and the upside potential. A futures hedge is also called a "*linear hedge*"² since the gains and losses on a futures contract are almost exactly proportional to the changes in the underlying cash price.

² Trading and Exchanges, "*Larry Harris*".

Yet, eligibility for cross hedging and case to case exemptions, calls for a lot of scrutiny by the exchanges and their regulators. No transactions are classified as bona fide hedges unless they are aimed at offsetting the price risks associated with spot operations.

Manipulation risk arises when traders know that they are technically bankrupt and have nothing to lose by massively increasing their positions. If the prices change so that their positions make money, they may escape their financial problems. But if prices change against them, those who guarantee the trades will suffer the losses.

Thus if a trader seeks exemptions for such above mentioned practices, exchanges may grant them a specific higher exemption level higher than the speculative limit. At times exchanges might simply disallow or have stricter restrictions on exemptions during the spot month.

For the compliance of speculative position limits, the principle of aggregation comes into action. Under this rule, all futures positions owned or controlled by one trader or a group of traders acting in concert are combined and subject to common ownership or control as if they were a single trader. As per the rules set by the exchange itself, clearing members may aggregate accounts under the same ownership within the same classification of customer segregated, customer secured, and special reserve account for the exclusive benefit of customers.

Coming back to the basic rationale behind speculative limits and margins, the fact is that an extremely volatile market is quite scary. Large price changes can quickly create, transfer or destroy enormous wealth. Though traders do not like extreme price changes, they can better accept them than when they happen due to fundamental valuation factors than when they are due to human folly. The most common mistake which is made by traders is overvaluation of their assets. They are overly optimistic about future prospects, or have not fully appreciated their risks. If enough traders share their enthusiasm, they push asset prices beyond fundamental values. The iceberg is felt when the traders lose confidence.

The National Commodity Exchange Limited (NCEL) is the first de-mutualized exchange in Pakistan, being the first fully electronic, geographically neutral exchange which has employed modern risk management techniques such as VAR (Value at Risk). Being fully electronic it ensures real time monitoring and reduction in the cost of doing business at the same time for the traders. Its fully active surveillance department to monitor position limits and disciplinary actions against their violations are set forth to ensure the much needed revolution in the futures trading mechanism and building of the trader's confidence level in Pakistan's exchanges.