

October 3, 2011

The Honorable Gary Gensler  
Chairman  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21<sup>st</sup> Street, N.W.  
Washington, DC 20581

**Re: Notice of Proposed Rulemaking - Position Limits for Derivatives**

Dear Chairman Gensler:

The International Swaps and Derivatives Association, Inc. (“ISDA”)<sup>1</sup> is writing in response to the Commodity Futures Trading Commission’s (“CFTC”) proposed rules establishing position limits on futures and option contracts in 28 exempt and agricultural commodities (the “Proposed Rule”)<sup>2</sup> and their economically equivalent swaps, pursuant to Section 737 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank”).<sup>3</sup> The Proposed Rule also contains provisions that would exempt certain *bona fide* hedging transactions from the position limits.

We appreciate the opportunity to provide comments on the Proposed Rule and are using this opportunity to expand on ISDA comment letters submitted in January and March of 2011, as well as ISDA's April 2010 comment letter regarding proposed CFTC rules to impose speculative position limits on referenced energy commodities.<sup>4,5</sup> As discussed in ISDA’s previous comment letters, we remain concerned that the Proposed Rule will, perhaps unintentionally, eliminate certain legitimate derivative risk-management strategies, including anticipatory and portfolio hedging.

The use of anticipatory and portfolio hedging strategies have been utilized by commercial energy firms to manage commercial risks related to commodity price exposure for years. The elimination of these hedging strategies would, among other things, frustrate the

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<sup>1</sup> Since 1985, ISDA has worked to make the global over-the-counter (“OTC”) derivatives markets safer and more efficient. Today, ISDA is one of the world’s largest global financial trade associations, with over 800 member institutions from 56 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers.

<sup>2</sup> Position Limits for Derivatives, 76 Fed. Reg. 4752 (Jan. 26, 2011) (to be codified at 7 C.F.R. pts. 1, 150, and 151).

<sup>3</sup> H.R. 4173 (111th Cong. 2d Sess. 2010).

<sup>4</sup> See, <http://www2.isda.org/dodd-frank/> for copies of ISDA’s April 2010, January 2011 and March 2011 comment letters.

<sup>5</sup> Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations, 75 Fed. Reg. 4143 (Jan. 26, 2010), withdrawn 75 Fed. Reg. 50950 (Aug. 18, 2010) (the “January 2010 Proposed Rules”).

ability of energy market participants to engage in routine business enterprise risk management. Further, preventing U.S. corporations from engaging in these risk management practices will severely limit market liquidity, which would have the perverse impact of increasing, rather than decreasing, volatility in energy prices. Furthermore, such restrictions could cause business and related employment to migrate to more favorable regulatory systems abroad.

The CFTC's position limits regime, in all its iterations, has always included some form of hedge exemption. The rationale is that energy market participants that use the markets to reduce the risks inherent in operating commercial enterprises are not in the market to speculate and should therefore not be constrained by speculative position limits in their legitimate hedging activities. Hedging benefits both the energy customer and the market participant because customers gain some insulation against price volatility, and energy providers can stabilize their cash flows, which is vital for U.S. jobs in the capital-intensive energy business. Commercial energy companies and a wide variety of other market participants have relied on the use of anticipatory and portfolio hedging for years, and the exemptions provided by the CFTC to market participants have evolved over time to address the hedging strategies implemented to mitigate and reduce an expansive range of commercial risks.

A more detailed description of our concerns follows below.

## **A. CFTC's Proposed Dodd-Frank Rule on Position Limits**

The Proposed Rule would significantly narrow the availability of the *bona fide* hedging transaction compared to its current iteration. For example, the current definition of *bona fide* hedging requires that a *bona fide* hedging transaction or position in a futures contract normally represents a substitute for a physical market. This is generally understood to be activity that normally, but not necessarily, represents a substitute for cash market transactions or positions. However, unlike the current definition, the Proposed Rule allows the exemption only for transactions that represent a substitute for a physical market transaction. We are concerned that the definition of *bona fide* hedges may be overly restrictive and that they may in fact be detrimental to the efficiency and competitiveness of the energy markets. The concern of many market participants is that the CFTC's interpretation of the definition appears to exclude legitimate hedging strategies, such as anticipatory and portfolio hedging, that are currently used by the industry, in favor of requiring rigid one-on-one hedging. This new definition would prevent market participants from effectively planning or entering into positions needed to hedge their short-term and long-term commercial risk or prevent them from doing so in a more cost-effective way. Consequently, energy market participants who are merchandising cash market positions would be restricted from obtaining a hedge exemption for anticipatory purposes.

In addition, energy market participants frequently need to exceed established speculative accountability levels and position limits in order to hedge unsold commercial production or unfilled anticipated commercial requirements. Under the Proposed Rule, energy

market participants would have to file a request for approval with the CFTC at least ten days in advance of the date that such positions would be in excess of the position limit. Because energy markets can be volatile and fast-moving, we believe that the approval process is unworkable in practice since the necessary hedge positions cannot be properly identified ten days in advance of exceeding the relevant position limit. Further, such a short time period is not practical and would be a cumbersome and ineffective way for commercial energy companies to adequately hedge price volatility, resulting in higher costs for customers. Further, the ten day notice requirement would not provide commercial energy firms with the flexibility to respond to and manage unforeseen commercial exposure in the event of a market disruption.

## **B. Energy Market Participants Manage Risk Through Hedging**

Energy market participants operate in environments subject to adverse price movements, often in volatile international markets. The exposure to this volatility may increase a company's costs or dramatically reduce its profits. For this reason, participants need to efficiently manage exposure to fluctuating commodity prices. One key tool used by energy market participants, particularly those active in oil and natural gas exploration, to manage this price volatility is anticipatory and portfolio hedging. Such companies regularly make extensive use of financial derivatives with the discrete purpose of ensuring a stable cash flow from which they can consistently fund their capital program to find and bring much needed energy resources to market. Hedging, whether using futures, options on futures, or over-the-counter derivatives, is used for cash flow efficiency and financial risk management related to commercial exposures incurred by commercial energy companies.

Limiting the ability of commercial energy companies to engage in anticipatory and portfolio hedging could severely limit their hedging and risk management activity, resulting in a reduction in market liquidity, as energy market participants are forced to transfer their risk management and hedging activity to jurisdictions outside of the U.S. Ultimately, this movement abroad would result in greater volatility in energy prices and a significant loss of U.S. jobs.

## **C. Energy Market Participants Engagement in Anticipatory Hedging**

Energy market participants build and manage a portfolio of physical supply, storage and transportation services in order to meet anticipated demand. For most, system demand varies dramatically, yet predictably, based on certain economic, weather, or supply factors. Energy companies are thus exposed to commodity risks and in general must forecast the anticipated demand on their systems and assess the underlying physical exposure associated with that demand. Many energy companies then determine if financial instruments are needed to mitigate all or a portion of that exposure. These needs may change or fluctuate, however, affecting these companies' use of the hedging exemption. For these reasons, participants need to have hedge exemptions in place that allow for anticipatory hedging well in advance of when their positions may be expected to exceed the applicable limits.

For example, in ordinary business operations, energy providers hedge the price exposures associated with cargoes of RBOB, finished gasoline, components and feedstocks with the NYMEX RBOB<sup>6</sup> futures contract. During times of refinery disruptions or weather-related issues, such as a hurricane, energy providers may bring in additional cargoes to New York Harbor to help supply their commitments or to help meet the needs of others in that regional market. However, their own needs or the needs of the market may change while the cargoes are *en route*.<sup>7</sup> As a result, although these cargoes have been commercially hedged pursuant to the *bona fide* hedging exemption and, although this is a legitimate commercial purpose for a *bona fide* hedger, ISDA is concerned that commercial hedgers could lose their ability to engage in such activity for regulatory rather than economic reasons because of the initial risk-management positions associated with these cargoes.

It is important to note that the energy market is a constantly evolving, dynamic market all along the supply chain. The demand for oil to process in a global refinery system, store in tankage or arbitrage between one region and the other is constantly changing with the dynamics of the overall market. Many refining systems estimate their future oil needs based on the economics of refining crude oil into products, which may change over time depending on a multitude of factors. These companies purchase crude oil loading in the future to lock in physical and pricing needs of which some can require hedging in benchmark future contracts. Further, energy providers consider buying benchmark oil to take delivery for their refining systems to process. However, as economics and market conditions change, these companies modify these different grades of crude oil and refined products by selling them and buying others. Energy providers are regularly planning their forward balances one to six months out. Finally, arbitrage and storage needs also fluctuate with changes in market structure and movements in forward curves where companies buy or sell futures to offset their pricing exposure and hedge physical movements of oil.<sup>8</sup>

#### **D. Energy Market Participants Engagement in Portfolio Hedging**

The importance of allowing energy market participants to use portfolio hedging is based on such participants' refining, production and supply businesses having diverse and complex exposures relating to benchmark crudes and products on a global basis. These companies hedge their activities as a portfolio to aggregate their internal exposures where

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<sup>6</sup> RBOB gasoline is a contract based on the largest single volume refined product sold in the U.S. (gasoline) which accounts for almost 1/2 of national oil consumption. RBOB gasoline futures and options trade in a highly diversified market, with hundreds of wholesale distributors and thousands of retail outlets, thus resulting in very competitive, intense price volatility.

<sup>7</sup> E.g., there is no longer a commercial need for one or more of these cargoes because more economical substitutes from elsewhere become available or a refinery disruption is resolved earlier than expected, and the business may ultimately have the ability to speculatively trade on one or more of these cargoes.

<sup>8</sup> As an example, crude oil can be bought in one region and shipped to another; *i.e.* South American crude pricing on WTI bought and shipped to European refineries, or in a different timeframe and stored before processing; *i.e.* Middle Eastern crude bought on a Brent pricing basis and shipped to the West Coast of the U.S. (a 35 day voyage) and held in tank before processing.

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possible and trade the net balances on exchanges. Hedges of physical production, physical supply, pricing exposure to movements of benchmarks, arbitrage from one region versus the other and time period hedges form a matrix of positions that are best hedged on a portfolio basis.

The complexity of the integrated energy business exposes market participants to several significant commercial risks. For example, portfolio hedging enables commercial energy companies to protect themselves against the following types of commercial risks: (i) Changes in the value of refinery selected cargos of crude loading in the world; (ii) Changes in run rates at a refinery in the U.S. or elsewhere due to an unexpected outage; (iii) Delays in transport of a cargo of crude oil resulting in the end users having to buy barrels (“bbls.”) in the spot market; (iv) Seasonal changes in specifications of a products (gasoline); and (v) Amendment of forecast of production from a well in the Gulf Coast due to hurricane or numerous other examples, are not separately hedged on individual accounts. Due to the sheer number of unforeseen changes, operational updates and number of potential events in one day (including geopolitical risks,) many commercial companies utilize portfolio hedging.

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ISDA appreciates the opportunity to provide these comments. Should you require further information, please do not hesitate to contact the undersigned.

Sincerely,



Robert Pickel  
Executive Vice Chairman

cc: The Honorable Michael Dunn  
The Honorable Jill E. Sommers  
The Honorable Bart Chilton  
The Honorable Scott D. O’Malia