ISDA International Swaps and Derivatives Association, Inc.

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Invested in America

March 28, 2011

Mr. David Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: **Notice of Proposed Rulemaking - Position Limits for Derivatives (RIN 3038-AD15 and 3038-AD16)**

Dear Mr. Stawick:

The International Swaps and Derivatives Association, Inc.[1] ("ISDA") and the Securities Industry and Financial Markets Association[2] ("SIFMA") are writing in response to the proposed rule issued by the Commodity Futures Trading Commission (the "CFTC" or the "Commission") regarding the imposition of speculative position limits on futures and option contracts in 28 exempt and agricultural commodities (the "Proposed Rules")[3] and their economically equivalent swaps, pursuant to Section 737 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank").[4] The Proposed Rules also contain provisions that address the aggregation of positions under common ownership for the purpose of applying the limits, as well as provisions that would exempt certain *bona fide* hedging transactions from the position limits. We are pleased to share these comments with the Commission, in addition to our comment letter submitted prior to the publication of the Proposed Rules in the Federal Register (the "January 2011 Comment Letter") and ISDA's comment submitted to the CFTC in connection with the proposed rules to impose speculative position limits on referenced energy commodities (the "April 2010 Comment Letter").[5]

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[1] ISDA, which represents participants in the privately negotiated derivatives industry, is among the world's largest global financial trade associations as measured by number of member firms. ISDA was chartered in 1985 and today has over 800 member institutions from 54 countries on six continents. Our members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the risks inherent in their core economic activities. For more information, please visit: www.isda.org.

[2] SIFMA brings together the shared interests of hundreds of securities firms, banks, and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, please visit: www.sifma.org

[3] Position Limits for Derivatives, 76 Fed. Reg. 4752 (Jan. 26, 2011) (to be codified at 7 C.F.R. pts. 1, 150, and 151).

[4] H.R. 4173 (111th Cong. 2d Sess. 2010).

[5] 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").

As set forth below, we are deeply concerned with many aspects of the Proposed Rules and we challenge the fundamental premise upon which the CFTC argues that it has authority to impose position limits under Dodd-Frank. For this reason, and based on the serious concerns discussed below and the concerns raised in the April 2010 and January 2011 Comment Letters, we do not believe that the Commission should go forward with either Phase One or Phase Two of the Proposed Rules.

In any event, while we endorse the separation of position limits into two distinct phases if the Commission does adopt the Proposed Rules, we believe that substantial changes to both Phase One and Phase Two of the proposed position limit regime should be made to achieve the Commission's objectives without unnecessarily harming or disrupting commodity markets. Specifically, the CFTC should postpone the implementation of Phase Two until a later date when it can demonstrate to all market participants that there is excessive speculation or threats of manipulation and that position limits, and particularly position limits away from the spot month, are necessary to address problems related to such threats. The CFTC has many tools at its disposal to address these concerns, and we encourage the CFTC to explore other options that would be less harmful to the markets instead of moving forward with Phase Two of the proposed position limit regime.

I. Introduction

The Proposed Rules would establish speculative position limits on 28 exempt and agricultural commodities. New Section 4a(a)(1) of the Commodity Exchange Act, as amended by Dodd-Frank (the "CEA"), authorizes the CFTC to extend position limits beyond futures and option contracts to swaps traded on a designated contract market ("DCM") or swap execution facility ("SEF") and swaps not traded on a DCM or SEF that perform or affect a significant price discovery function ("SPDF") with respect to regulated entities,[6] that "are necessary to diminish, eliminate, or prevent" the burden of excessive speculation. New Section 4a(a)(2) of the CEA authorizes the CFTC to "establish limits on the amount of positions, as appropriate" that a person may hold with respect to futures or options contracts traded on or subject to the rules of a DCM. New Sections 4a(a)(2)(B) and 4a(a)(3) of the CEA authorize the Commission to set spot-month, single-month and all-months-combined limits for DCM futures and option contracts on exempt and agricultural commodities within 180 and 270 days, respectively, of the Dodd-Frank Act's enactment.

Further, new Section 4a(a)(5) of the CEA authorizes aggregate position limits for swaps that are economically equivalent to DCM futures and option contracts with CFTC-imposed position limits. Similarly, new Section 4a(a)(6) of the CEA requires the CFTC to apply position limits on an aggregate basis to contracts based on the same underlying commodity across: (1) DCMs; (2) with respect to foreign boards of trade ("FBOTs") contracts that are price-linked to a DCM or

[6] We note that such category of swaps would include standardized, over-the-counter ("OTC") swaps, but not customized, uncleared swaps.

SEF contract and made available from within the United States via direct access; and (3) SPDF swaps (including OTC swaps).

New Section 4a(a)(3) of the CEA qualifies the CFTC's authority by directing it to set such position limits, "as appropriate. . . [and] to the maximum extent practicable, in its discretion: (i) to diminish, eliminate, or prevent excessive speculation . . ; (ii) to deter and prevent market manipulation, squeezes, and corners; (iii) to ensure sufficient market liquidity for *bona fide* hedgers; and (iv) to ensure that the price discovery function of the underlying market is not disrupted." Congress, by directing the CFTC to consider not only excessive speculation and market manipulation, but also market liquidity and price discovery, intended to strike a balance between these competing aims.

However, the Proposed Rules do not set forth why the proposed limits are "necessary" or "appropriate." Instead, the proposing release of the Proposed Rules (the "Release") declares that the

> Commission may impose position limits prophylactically, based on its reasonable judgment that such limits are necessary for the purpose of "diminishing, eliminating, or preventing" such burdens on interstate commerce that the Congress has found result from excessive speculation. A more restrictive reading would be contrary to the congressional findings and objectives as embodied in section 4a of the Act.[7]

For the reasons set forth below, we respectfully submit that this is not a legally supportable justification. Dodd-Frank does not provide the CFTC with "prophylactic" authority to impose position limits on commodity markets. Instead, Dodd-Frank mandates that the CFTC impose position limits "as appropriate," and "as appropriate," we submit, requires factual support for position limits based on "diminish[ing], eliminating, or prevent[ing] excessive speculation" or "deter[ring] and prevent[ing] market manipulation balanced against the impact on "market liquidity" and "price discovery." There is no such factual support and the Commission cites to none.[8] Therefore, we believe that the imposition of position limits "prophylactically"[9] is neither mandated by Dodd-Frank nor supported by facts.

Furthermore, given that new section 4a(a)(2) provides the CFTC with the general authority to establish position limits, subject to the qualifications that the limits be "appropriate" and set in accordance with the goals set forth in section 4a(a)(3), the specific authority provided to the

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[7] 76 Fed. Reg. at 4754.

[8] This view is shared by economists within the CFTC, including one who noted in August 2009 that it was pointless to devise solutions to a problem that might not exist, since "I think of a position limit as a tool," and since "[w]e have no statistical evidence of a problem, we are not able to calibrate the tool to fix the problem." Sarah N. Lynch, CFTC Documents Reveal Internal Debate on Position Limits, Wall St. J. Online, May 14, 2010, available at http://online.wsj.com/article/SB10001424052748704635204575242313250906300.html.

[9] 76 Fed. Reg. at 4754.

CFTC in sections 4a(a)(5) and 4a(a)(6) must be read in light of the section 4a(a)(2) general authority and the statutory objectives of section 4a(a)(3). The authority to impose limits on economically equivalent swaps in section 4a(a)(5) is premised on providing consistent treatment between swaps and futures or option contracts.[10] Similarly, the aggregate limits in section 4a(a)(6) are designed to "prevent regulatory arbitrage and ensure a level playing field for all trading venues."[11] In order to develop position limits that prevent regulatory arbitrage and ensure a level playing field across trading venues, we believe that the Commission should not impose arbitrary position limits under sections 4a(a)(5) and 4a(a)(6). Instead, the Commission must impose limits under sections 4a(a)(5) and 4a(a)(6) that are "appropriate" and are consistent with statutory objectives of section 4a(a)(3), namely, to protect against excessive speculation and manipulation while ensuring that the markets retain sufficient liquidity and their price discovery functions.

The Release states that the Commission is not required to demonstrate that "position limits are necessary to prevent sudden or unreasonable fluctuations or unwarranted changes in prices or otherwise necessary for market protection."[12] We respectfully disagree. New Section 4a(a)(1) of the Commodity Exchange Act ("CEA") explicitly requires the Commission to impose position limits that "are necessary to diminish, eliminate, or prevent" the burden of excessive speculation. We believe that the Commission should not adopt a comprehensive position limit regime when it lacks data demonstrating price fluctuation caused by excessive speculation or the ability of position limits to reduce excessive speculation or market manipulation. We believe that, by directing the CFTC to set limits "as appropriate," Congress intended to provide the Commission with the discretion necessary to design a position limit regime in a manner that protects and enhances the existing liquidity of the markets and provides adequate price discovery for commercial entities and other market participants. We urge the Commission to develop Proposed Rules that reflect the necessary balance of these considerations.

We believe that the Commission cannot set appropriate position limits that ensure market liquidity and price discovery without, at minimum, evidence demonstrating that excessive speculation exists or that position limits will reduce excessive speculation. In the absence of evidence regarding the impact of excessive speculation, it would be impossible to set position limits that comply with the mandates set out in Dodd-Frank that position limits provide "sufficient market liquidity for *bona fide* hedgers" and "ensure that the price discovery function of the underlying market is not disrupted." As Commissioner Dunn stated in his opening statement at the CFTC's January 2011 open meeting (the "January Meeting"), "[t]o date, CFTC staff has been unable to find any reliable economic analysis to support either the contention that excessive speculation is affecting the markets [the CFTC] regulate[s] or that position limits will prevent excessive speculation." Commissioner Dunn's statement echoes a longstanding search

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[10] *See* 76 Fed. Reg. at 4755 ("Because it has the authority to gather data and impose regulations across trading venues, the Commission is uniquely situated to establish uniform position limits and related requirements for all economically equivalent derivatives. A uniform approach would also encourage better risk management and could reduce systemic risk.").
[11] *Id.*
[12] *Id*. at 4754.

for, but failure to find, evidence of excessive speculation. Moreover, even those who have alleged (without support) that excessive speculation exists have not proffered evidence that position limits would (or have) reduced such excessive speculation.

Numerous studies have been commissioned to assess the presence and effect of excess speculation in commodities markets, and they have universally found no discernible evidence of excessive speculation. For example, in March 2009, the Task Force on Commodity Futures Markets of the International Organization of Securities Commissions ("IOSCO"), co-chaired by the CFTC and the United Kingdom's Financial Services Authority, determined that market fundamentals, not speculation, caused the price volatility in physical commodities markets in 2008.[13] Similarly, the International Monetary Fund's World Economic Outlook, published in October 2008, found that "there is little discernable evidence that the buildup of related financial positions [in commodity markets] has systematically driven either prices for individual commodities or price formation more broadly."[14] Similar conclusions were reached by the CFTC Inter-Agency Task Force on Commodity Markets,[15] the European Commission,[16] and the Government Accountability Office.[17] Most recently, a report being prepared by the Organization for Economic Cooperation and Development for the April 2011 G-20 meeting indicates that the main factor behind rising commodity prices is not speculators but rising global consumer demand that is outstripping supply.

Additionally, a January 2009 memo prepared by the Government Accountability Office (the "GAO Memo") found, based on both public and non-public data, "limited evidence" that speculation causes changes in commodity prices. The GAO Memo reviewed numerous empirical studies, all of which "generally employed statistical techniques that were designed to detect a very weak or even spurious causal relationship between futures speculators and commodity prices," and concluded that "the fact that the studies generally did not find statistical evidence of such a relationship appears to suggest that such trading is not significantly affecting commodity prices at the weekly or daily frequency." Moreover, the GAO Memo looked at index traders specifically, in addition to speculators generally, and concluded that there was "limited statistical evidence of a causal relationship between speculation in futures markets and changes in commodity prices – regardless of whether the studies focused on index traders, specifically, or speculators, generally."

Given the lack of conclusive evidence of excessive speculation or market manipulation that would warrant the imposition of position limits, it is problematic that the Commission has not conducted a robust economic analysis on the impact of the Proposed Rules on the markets and

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[13] Task Force on Commodity Futures Markets Final Report, Technical Committee of the International Organization of Securities Commission (March 2009).
[14] World Economic Outlook, International Monetary Fund (October 2008).
[15] Interagency Task Force on Commodity Markets, Interim Report on Crude Oil, Washington D.C.
[16] First Interim Report on Oil Price Developments and Measures to Mitigate the Impact of Increased Oil Prices, European Commission (1 September 2008).
[17] Issues Involving the Use of the Futures Markets to Invest in Commodity Indexes, Government Accountability Office, at 5 GAO-09-285R Commodity Indexes (January 30, 2009).

market participants. As Commissioner Sommers noted, the Commission has consistently failed to conduct a "thorough and meaningful" cost-benefit analysis on the Proposed Rules promulgated by the CFTC under Dodd-Frank. Given the significant financial and regulatory burdens the Proposed Rules will impose on market participants, and the resulting loss of liquidity, increase in volatility in commodity markets and increased hedging costs, the failure to conduct such an analysis suggests that the Commission cannot provide any economic justification for the Proposed Rules. Indeed, the loss of liquidity alone may increase volatility in the markets, which is precisely what the Commission seeks to avoid. While Chairman Gensler has asserted that Section 15(a) of the CEA does not require the Commission to quantify the cost of the Proposed Rules, we are deeply troubled that the Commission has failed in any meaningful way to consider the costs of the Proposed Rules on market participants. We urge the Commission to quantify the costs of the Proposed Rules and to provide this analysis to the public, before moving forward with the imposition of position limits.

Despite our concerns, if the Commission nevertheless does move forward with the Proposed Rules, we believe the Commission must make significant changes to the position limit regime, as we suggest below, to protect the liquidity and price discovery function of the markets, and to prevent harmful and unnecessary disruptions to the markets.

II. Phase One

We believe that the Commission should modify Phase One of the position limit regime, to minimize the disruption to the commodity markets and market participants that rely on them for their price discovery function and to hedge their commercial risk.[18]

Conditional Limit for Cash-Settled Contracts

Under Phase One, the Commission would set an initial spot-month position limit on futures and swaps, based on limits currently imposed by designated contract markets and exempt commercial markets. Specifically, under the Proposed Rules, a trader holding financially-settled contracts would be subject to a spot-month speculative position limit of five times the level fixed for the financially-settled contract's physically-settled counterpart if the trader holds no physically-settled contracts in the spot month. Otherwise, traders would be subject to the same limit for financially settled positions in the spot month as for a physically settled contract.

As discussed below, we believe that it is appropriate for the Commission to distinguish between the spot-month and outer months, as market volatility, and therefore opportunities for market manipulation, are dramatically lower in the outer months. We believe that in imposing position limits, the Commission should focus its efforts in the spot month. However, even with respect to the spot month, we believe that financially-settled contracts are beneficial to commodity markets

[18] We note that the imposition of different spot-month position limit regimes in Phase One and Phase Two will require market participants to create two different systems to monitor spot-month position limits, which we believe is a significant and unnecessary cost to market participants.

and we urge the CFTC to reconsider whether it should place restrictions on these products, absent clear evidence of excessive speculation or market manipulation in these markets.

We believe that the conditional spot-month limit for cash-settled contracts should not be limited to those market participants that do not have positions in physically-settled contracts. The Proposed Rules should permit use of the conditional spot-month limit even when a trader holds spot-month positions in physically-settled contracts up to a specified threshold, as traders with large financial positions do not present a meaningful risk of manipulating the market simply by virtue of having positions in physical delivery contracts.[19] Moreover, by allowing high conditional limits for financially-settled contracts only for those traders with no physically-settled positions, the Proposed Rules artificially incentivize institutions to move to financially-settled contracts in the spot month and exit their physically-settled positions. This will reduce liquidity and the price discovery functions of these physical markets, harming price discovery and the price integrity of the contracts at settlement, as large traders moving out of physically-settled contracts in the spot month likely will create market disruptions and price distortions.

Furthermore, given that financially-settled contracts do not influence the settlement price of physically-settled contracts, as financial contracts settle *against* the physical contracts, we disagree with the CFTC's conclusion that "the proposed spot-month position limit formula is consistent with industry practice and the goals of preventing manipulation through corners or squeezes."[20] In addition, neither the Proposed Rules nor the Release provide any justification as to why is it "necessary" or "appropriate" to restrict the conditional spot-month limit to five times the limit for physically-settled contracts. We believe this conditional limit is arbitrary and the restrictions on the conditional limit will result in a significant amount of unnecessary trading and more volatility as traders have to unwind previously existing positions. Moreover, it would make the market more dependent upon smaller traders merely by virtue of their size and without regard to their ability or willingness to provide the best price.

Therefore, we strongly urge the Commission to permit market participants that hold some physically-settled contracts to avail themselves of the higher cash-settled limits. We would be pleased to work with the Commission to identify a size of physically-settled positions that would not be disruptive.[21]

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[19] The Commission's conclusion—that for a participant to hold larger financial positions it can hold no physically-settled contracts—is arbitrary and unsupportable. We are aware of the Commission's complaint against Amaranth Advisors L.L.C. and its subsequent settlement. The Commission alleged that Amaranth's physically-settled futures position was developed to influence the settlement price and benefit Amaranth's large financially-settled positions. While this strategy ultimately was a disaster for Amaranth, it was allegedly dependent on orders being placed in a manner to artificially affect futures prices. The Commission has ample anti-manipulation authority to address these types of situations. Arbitrary position limits are not the regulatory tool to address this issue.

[20] 76 Fed. Reg. at 4757.

[21] In addition, the ability to utilize the conditional spot-month will require traders to monitor, on an intraday basis, their cash or forward positions of the referenced contracts, to ensure they do not hold more than 25% of the deliverable supply of these commodities. This will impose a new and significant regulatory burden on market participants, which we believe is unnecessary.

Scope of Phase One Limits

We are concerned that the interim spot-month limits will reduce liquidity, as the interim position limits will aggregate across trading venues, as opposed to providing a separate limit for each trading venue, and will apply to uncleared OTC swap contracts. As a result, hypothetically a market participant that is currently permitted to hold 5,000 swap contracts on ICE and 5,000 swap contracts on ClearPort and unlimited uncleared OTC swap contracts will now be restricted to holding 5,000 swap contracts across ICE and ClearPort, and must include all uncleared swap contracts under this same 5,000 contract limit. These new limits will immediately impose restrictions on market participants by limiting the trading of cleared swaps that will reduce liquidity and hamper the price discovery function of these markets.

In addition, these interim limits will inhibit OTC swap trading when the Commission has no idea of the size of that market. As with Phase Two, discussed in Part V below, we recommend that the Commission use Phase One to continue to gather data regarding the OTC swaps markets so that the Commission can make a more informed decision regarding position limits on OTC swaps in the future. Given that the CFTC does not have data on the size or structure of the OTC swaps market for the 28 referenced commodities, we believe that it would be premature for the Commission to impose the spot-month limit on OTC swaps. Until such time as the Commission has data regarding the OTC swaps market, it is impossible for the Commission to set appropriate position limits on these contracts without severely impairing the liquidity and price discovery functions of the commodity markets.

III. Exemptions

We recommend that the Commission revise the criteria by which it proposes to grant exemptions from the position limits, before the implementation of Phase One position limits. A wide variety of market participants have relied on exemptions from position limits for years, and the exemptions provided by the Commission to market participants have evolved over time to address the hedging strategies implemented to mitigate and reduce an expansive range of commercial risks. We are concerned that a narrow interpretation of the exemptions by the Commission will greatly restrict normal hedging activity, limiting the ability of market participants to manage and reduce their financial and commercial risks.

Broadened Authority Under the CEA

New Section 4a(a)(1) of the CEA gives the Commission authority to set aggregate position limits by "group or class of traders," and new Section 4a(a)(7) of the CEA gives the Commission authority to provide exemptions from these position limits to any "person or class of persons." We strongly urge the Commission to exercise this broadened exemptive authority. At the January Meeting, Commissioner Sommers also noted that neither the Release nor the Proposed Rules "analyze, or in any way consider, whether different limits are appropriate for different groups or classes of traders." We concur and we encourage the Commission to explore whether it would be

more appropriate to treat categories of market participants differently, based on their respective uses of commodity derivatives, their role in the commodity markets and other factors.

As an example, we believe the Commission should provide a larger position limit to passive, unleveraged investment entities. These market participants perform a vital role in the commodity markets, by bringing new capital and liquidity to the markets, enhancing their price discovery function, and facilitating the ability of commercial market participants to hedge their price exposures. There is no evidence that these entities engage in excessive speculation or that they affect fundamental market dynamics.[22] In fact, because they are unleveraged, they are unlikely to have any material effect on market prices and we believe that the imposition of onerous restrictions on these market participants will serve only to impair price discovery further out on the forward curve for many commodities, where many commercial producers hedge their financial risks. Such restrictions will also unnecessarily constrain liquidity in the futures market for commercial users, and will increase the cost and limit the ability of end-users to hedge their commercial and financial risks.

Pass-Through of Position Limits to Counterparty

While the statutory definition of a *bona fide* hedge in Section 4a(c)(2) of the CEA is generally consistent with the existing definition in CFTC Regulation § 1.3(z)(1), the Proposed Rules restrict the ability of a counterparty to utilize the position limits that their OTC counterparties might have available to them except for *bona fide* hedging transactions. In our view, such a restriction on "pass-through" is in no way required by Dodd-Frank and will be harmful to dealer and end-user alike. Given the Commission's expanded authority under Dodd-Frank, we believe there is no ability for a counterparty to evade the position limits through a transaction with a *bona fide* hedger, as the Commission now has authority to impose limits on swap positions.

As stated in our January 2011 Comment Letter, we believe the Commission should use the broad exemptive power given to it under new Section 4a(a)(7) of the CEA to allow market participants to utilize the position limits that their OTC counterparties might have available to them, regardless of the classification of those counterparties or the nature of their activities. Allowing financial intermediaries to rely on their counterparties' position limits is warranted because the intermediation function that these market participants, such as swap dealers, perform does not increase the level of activity in the markets; it merely transfers net risk from one execution venue to another.

While we acknowledge the Commission's efforts to allow this pass-through in the context of *bona fide* hedging, we believe it should be extended to all trading activity. If any market participant remains under its position limit, a counterparty dealer should be permitted to carry the position limit (*e.g.*, to permit futures or swaps trading) of that counterparty, up to the position

[22] A draft report by an interagency task force led by CFTC staff in 2009, obtained by The Wall Street Journal through the Freedom of Information Act, around January 2009, stated "there is not enough evidence to support the argument that the commodity index funds cause price spikes in commodities." Sarah N. Lynch, CFTC Documents Reveal Internal Debate on Position Limits, Wall St. J. Online, May 14, 2010.

limit that is applied to such counterparty. We believe that an overwhelming amount of near-term hedging activity of consumers and producers is traded in the market by financial intermediaries. If swap dealers are unable to use the position limits available to both sides of the market, they will not be able to accommodate *bona fide* hedging or other risk management services for market participants, thus diminishing and impairing market liquidity. This will in turn raise the cost of hedging transactions utilized by end-users, limiting their ability to manage effectively their commercial and financial risks.

In addition, we urge the CFTC to clarify that dealers would be permitted to use the hedge exemption of a counterparty, even if the counterparty's positions are not already above the applicable speculative limits. Our concern is that proposed § 151.5(g) allows one party to rely on a *bona fide* hedge exemption only when its counterparty "exceeds" the speculative limits under proposed § 151.4. While not entirely clear, we urge the CFTC, at a minimum, to confirm that *bona fide* hedge exemptions would be passed through to counterparties, whether or not the *bona fide* hedging counterparty's positions are above the speculative limit. Furthermore, as the Commission has done in the past, it should continue to permit the pass-through of limits on a global hedging basis, by looking through a transaction to the ultimate hedging party, even if there is an entity between the hedging party and the intermediating party.

<u>Requirements to Obtain a *Bona Fide* Hedge Exemption</u>

The Proposed Rules create additional regulatory burdens on *bona fide* hedging transactions that we believe will impose onerous, unnecessary and harmful requirements on *bona fide* hedgers, and we urge the CFTC to reconsider the imposition of these requirements.

Under the current reporting obligations for hedge exemptions, a market participant is required to apply for a hedge exemption in advance of the anticipated need for such exemption, and the market participant is then provided with a safe harbor, should it exceed its speculative limits. This system allows a market participant effectively to manage its trading book by knowing in advance it has a hedge exemption that will allow it to grow its position to cover current and future hedging needs. However, the Proposed Rules appear to eliminate the ability of a market participant to apply for a hedge exemption in advance, except for limited circumstances, and only permits a market participant to apply for a hedge exemption up to its current hedging needs with the risk that the contemporaneous request could be rejected. This approach will prevent a market participant from planning or anticipating the correct level of positions needed to hedge its short-term and long-term commercial risk.

The current definition of *bona fide* hedging in § 1.3(z) of the CEA requires that a *bona fide* hedging transaction or position in a futures contract *normally represents* a substitute for a physical market, generally understood to be activity that normally, but not necessarily, represents a substitute for cash market transactions or positions. We are concerned that the CFTC's interpretation of the definition of *bona fide* hedging appears to require "one-to-one" hedging, which would not permit entities hedging commercial risk to do so on a portfolio basis, which is currently the manner in which commercial market participants typically manage their commercial

risk. Absent clarification, to comply with the new *bona fide* hedging regime, market participants will need to identify at the time of the trade that it is a *bona fide* hedging transaction, which is inconsistent with current market practices. We also believe such an approach will make it very difficult for commercial producers to manage larger risks that may require several transactions with various dealers to complete, given that such transactions could take weeks or months to hedge fully.

More troubling, Proposed CFTC Rule § 151.5(a)(2) only recognizes *bona fide* hedging for derivatives if such transactions or positions are one of the enumerated *bona fide* hedging transactions under Proposed CFTC Rule § 151.5(a)(2). In doing so, the Proposed Rules appear to eliminate the ability of market participants to enter *bona fide* hedging transactions pursuant to Proposed CFTC Rule § 151.5(a)(1) that are not enumerated hedging transactions under Proposed CFTC Rule § 151.5(a)(2). For example, these modifications to the current *bona fide* hedging regime appear to restrict the ability of market participants who are merchandising cash market positions to obtain a hedge exemption for anticipatory purchases, unless the market participant was acting as an agent pursuant to Proposed Rule § 151.5(a)(2)(iv) and will eliminate *bona fide* hedge exemptions for market participants that are purchasing a service, such as natural gas transportation, that would be available under Proposed Rule § 151.5(a)(1)(iii)(C), but is not an enumerated hedging transaction under Proposed Rule § 151.5(a)(2). In addition, the Proposed Rules, by rejecting CFTC Rule 1.3(z)(3), appear to eliminate all non-enumerated hedging transactions that have been well accepted by the industry and have not been the cause of any manipulation or other concerns.

In addition, by taking over the *bona fide* hedging regime that has long been implemented by DCMs and utilized by a wide variety of market participants for numerous commodities and replacing it with the narrower regime contemplated in the Proposed Rule that has only been utilized for agricultural commodities, the CFTC will eliminate hedging transactions that have long been relied upon by market participants, such as arbitrage hedging and cross-commodity hedging in the spot month, even though Section 4a(a) explicitly provides the Commission with authority to exempt from the position limits or to impose different limits on spread, straddle, or arbitrage trades.[23] Furthermore, as a result of the restriction of *bona fide* hedging transactions to the enumerated hedging transactions, the Proposed Rule will effectively eliminate the "pass-through" of the position limits for *bona fide* hedge transactions, as contemplated in Proposed Rule § 151.5(a)(1)(iv)(A). We suspect this is a drafting error and urge the Commission to clarify that this is not the intent of the Proposed Rule.[24] We do not believe these onerous restrictions are mandated by Dodd-Frank and as discussed above, we believe that the Commission has broad authority to continue to provide *bona fide* hedging exemptions that market participants have long relied upon.

[23] Proposed Rule § 151.5(a)(2)(v) permits cross-commodity hedging, but without justification prohibits the hedges during the last five trading days of the referenced contract.

[24] We also urge the Commission to clarify the difference between sales of *commodity underlying referenced contracts* and purchases of *referenced contracts* under Proposed Rule § 151.5(a)(2)(i). If the distinction is deliberate, we ask that the Commission provide an explanation as to why such a distinction was made and the practical implications of such a distinction.

These restrictions will be exacerbated by the requirements that the hedging party provide its counterparty with written certification that the transaction is a *bona fide* hedging transaction and notify its counterparty when it liquidates the initial hedging transaction. Under the Proposed Rules, upon entering into a *bona fide* hedging transaction, the counterparty "not hedging a cash market commodity risk" must: (i) ask for a written representation from its counterparty verifying that the swap qualifies as a *bona fide* hedging transaction, and (ii) upon receipt of such written representation from the counterparty, provide written confirmation of such receipt to the counterparty. These disclosure requirements will impose an unnecessary regulatory burden on market participants using *bona fide* hedge exemptions, as they will have to determine before they enter into a trade that it is a *bona fide* hedge; they must then provide the counterparty to a trade with a written representation that the transaction is a *bona fide* hedging transaction; and the counterparty must then acknowledge the written representation, all of which must occur in real time before the transaction is executed.

Furthermore, while the counterparty to the hedging transaction is permitted to trade in and out of the hedging position, it can only do so if the *bona fide* hedge representation from the commercial producer is still applicable. Therefore, the *bona fide* hedger is required immediately to notify its counterparty if it has liquidated its hedging transactions, and the counterparty then must do so as well. It may not be possible for the dealer to liquidate its position immediately through an offsetting transaction, and we do not believe that dealers should be penalized in such situations. These disclosure requirements place a significant regulatory burden on the *bona fide* hedging party and place that party at a disadvantage vis-à-vis its counterparty, as it is required to disclose its trading positions. We believe that these requirements are onerous and unnecessary and do not further any goals articulated by Section 737 of Dodd-Frank. We strongly urge the Commission to retain the existing *bona fide* hedge exemption regime that a wide variety of market participants have relied on and which has not caused any problems to date, and to extend the existing *bona fide* hedge exemption regime to other eligible market participants to enhance market liquidity and price discovery in the referenced contracts.

In addition, each party engaged in *bona fide* hedging must file a report on its cash positions with the CFTC no later than 9:00 am *on a daily basis*, until its positions are below the speculative limit, which we strongly believe is an unnecessary regulatory burden on market participants. We also question the extent to which the CFTC will have the resources to collect and analyze these daily reports. We note that market participants in different time zones would be required to develop systems or use additional resources to comply with these requirements that may require them to file reports with the CFTC outside of normal working hours. We question the ability of market participants, even sophisticated market participants, to develop systems that can accurately capture and report this information on a timely basis. We note that under the current *bona fide* hedging regime for agricultural commodities, market participants are not required to report their positions to the CFTC on a daily basis.

Commission Should Certify *Bona Fide* Hedging Activity

However, if the CFTC declines to retain its existing *bona fide* hedging regime, we believe that a party seeking a *bona fide* hedge exemption from the new position limits should be certified as a *bona fide* hedger directly by the CFTC rather than relying on the disclosure of its hedge to its counterparty. This approach would eliminate some of the problematic requirements, as discussed above, of the *bona fide* hedging regime under the Proposed Rules.

The purpose of the *bona fide* hedge exemption is to prevent speculative position limits from hindering the ability of companies to use the commodities markets to discover prices and hedge commercial risk. A CFTC certification process is consistent with this purpose in that it provides a company assurance that it is indeed qualified to rely on a *bona fide* hedging position exemption.[25] It also assures confidentiality and avoids what would otherwise likely involve the disclosure of confidential information of an end-user to a dealer. We believe that relying on private representations that are not backed by the authority of the CFTC, as required under the Proposed Rules, introduces an added element of litigation risk, namely that the CFTC will disagree with the party's determination that it is entitled to the *bona fide* hedge exemption. This increased risk decreases the incentives for businesses to participate in the futures and swaps markets, hinders the ability of businesses to manage risk, and reduces market liquidity.

Entities should be able to represent to the CFTC that they are commercials that primarily engage in *bona fide* hedging and are entitled to CFTC certification, and on that basis the dealer or other counterparty should be able to rely on the CFTC certification in offsetting their positions in the market. We believe that CFTC certification of *bona fide* hedging status should be on an entity-by-entity basis rather than a trade-by-trade basis, given that approaching *bona fide* hedge certification on a transaction-by-transaction basis is inconsistent with end-users' businesses, is administratively complex, and unrealistically assumes that parties know which transactions are hedges or speculative in real time, rather than after reconciling positions.

IV. Aggregation

Under the Proposed Rules, positions will be required to be aggregated with any positions in which any trader has a ten percent or greater equity interest. As noted in the April 2010 and January 2011 Comment Letters, respectively, we strongly oppose this provision. The Release notes that with regard to the account aggregation provision in the January 2010 Proposed Rules, which contained only a very narrow exemption for certain passive pool participants, "[s]everal commenters, including the CME Group, Electric Power Supply Association, Futures Industry Association, GDF Suez Energy, Morgan Stanley, and NextEra Energy Power Marketing, expressed concerns relating to the potential for overly strict account aggregation standards."[26] In

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[25] An entity should be permitted to submit to the CFTC a certification which indicates that it hedges risks that it or its affiliates incur to cover situations where an entity (*e.g.*, a parent company) enters into an inter-affiliate transaction with an affiliate (*e.g.*, a subsidiary that owns a power plant) that hedges a risk incurred directly by the affiliate and then enters into a transaction with a dealer to hedge the affiliate's risk.

[26] 76 Fed. Reg. at 4756.

an attempt to address these concerns, the Proposed Rules would provide limited exemptions from the aggregation requirement for positions held by "pools," FCMs, and for positions of independently controlled and managed traders that are not financial entities, upon application to and approval by the Commission. According to the Release, the Proposed Rules would address the concerns with the elimination of the independent account controller exemption "by establishing the owned non-financial entity exemption."[27] We believe this concession is inadequate, and that the elimination of the independent account controller exemption for financial entities will cause significant disruption to the markets. We urge the Commission to eliminate or revise this provision.

Independent Account Controller Exemption

Under the Proposed Rules, the owned non-financial entity exemption would allow an entity to disaggregate (1) the positions of a non-financial entity in which it owns a ten percent or greater ownership or equity interest from (2) its own directly held or controlled positions and the positions attributed to it (through the general ten percent ownership standard or other aggregation requirements of the proposed regulations), if it can demonstrate that the owned non-financial entity is independently controlled and managed.[28]

According to the Release, "Under the proposed standards, the Federal position limits in referenced contracts would apply to all positions in accounts in which any trader, directly or indirectly, has an ownership or equity interest of 10 percent or greater or, by power of attorney or otherwise, controls trading."[29] As an initial matter, we are concerned that the Commission would impute "control" over positions up the corporate ladder of a market participant, as it would to determine "ownership" over positions, regardless of whether or not there is any actual (or even indirect) control over the positions at the higher corporate level. As a result, the aggregation requirement could be triggered when a corporate entity has neither ownership nor control over the positions being aggregated. As an example, the 10% ownership test in the Proposed Rule would impute ownership to an entity that held a passive 10% equity interest in a fund manager, thus requiring the entity to aggregate all of its positions in any funds under management, even though the entity had no actual interest in the positions (they are held by the investors in the various funds) and had no actual control over either the fund manager or its trading. Therefore, we urge the Commission to clarify that, in the absence of any ownership interest (direct or indirect) in the positions, the Commission should use a "control" test to confirm whether or not the two entities should be subject to aggregation. If there is no actual control over the trading, then there is neither ownership nor control and the aggregation requirement should not be triggered.

The independent account controller exemption has long been relied upon by market participants and its elimination will severely disrupt the commodity markets. The Proposed Rules fail to

[27] *Id.*
[28] We urge the Commission to clarify how the Proposed Rule would address disaggregation of positions among market participants that might have both financial and non-financial entities within the same corporate structure and/or invest in entities that have both financial and non-financial entities within their corporate structure.
[29] 76 Fed. Reg. 4762.

provide any meaningful discussion as to why the exemption should not be available to financial entities that implement the required information barriers between traders. In support of the elimination of the account controller exemption, the Release argues that given the "high" limits that would be imposed under the Proposed Rules,[30] "[a]llowing traders to establish a series of positions each near a proposed position limit, without aggregation, may not be appropriate." In addition, the Proposed Rules assert that the current disaggregation exception for eligible entities "may be incompatible with the proposed Federal position limit framework and used to circumvent its requirements." [31]

Significantly, the Commission's proffered reasons supporting the elimination of the account controller exemption are unrelated to the underlying concern presented by aggregating positions among commonly owned entities. The rationale for aggregating positions is the concern that commonly owned entities may share sensitive information regarding their trading strategies and positions, or may otherwise be aware of each other's strategies and positions, and expressly or indirectly trade in tandem, thereby increasing the risk of market manipulation or destabilization. However, provided that well-designed institutional information barriers between traders are in place and are reasonably structured to prevent coordinated market trading by, or information flows between, separate entities, it is possible to address this concern without eliminating the account controller exemption. Such barriers are equally effective in financial as in non-financial firms and in fact, are likely to be more effective given the long tradition and longstanding regulatory requirements with respect to information barriers in financial firms; therefore, treating financial entities differently from non-financial entities in this regard is unnecessary and unwarranted. Indeed, requiring aggregation of accounts despite adequate separation through well-defined informational and institutional barriers will restrict the size of the positions that may be held by financial entities in the markets, which will in turn significantly reduce market liquidity and raise the cost of risk management for all market participants, including non-financial entities.

Furthermore, the Commission clearly believes that informational barriers are effective within financial institutions, as it recently issued proposed rules, pursuant to Section 731 of Dodd-Frank to require swap dealers and MSPs to "establish structural and institutional safeguards to ensure that the activities of any person within the firm * * * acting in a role of providing clearing activities or making determinations as to accepting clearing customers are separated by appropriate informational partitions within the firm from the review, pressure, or oversight of persons whose involvement in pricing, trading, or clearing activities might potentially bias their judgment or supervision and contravene the core principles of open access and the business

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[30] As an initial matter, we note that the Proposed Rules would retain the all-months-combined position limits for enumerated agricultural commodities in current CFTC Regulation § 150.2. As a result, market participants would be subject to current position limits for agricultural commodities, without the benefit of disaggregating positions that are independently controlled. Moreover, as discussed above, the limits are significantly narrower for the enumerated commodities in the spot month where a single limit has to be shared by the cleared and bilateral swaps markets.

[31] 76 Fed. Reg. at 4762.

conduct standards described in this Act." This proposed rule[32], adapted from National Association of Securities Dealers (NASD) Rule 2711, would require swap dealers and MSPs to establish informational partitions between (1) persons making clearing determinations and (2) persons involved in pricing and trading swaps (*i.e.*, risk-taking units). The Commission, in proposing this rule, clearly recognizes that this interpretation would protect against potential bias or interference in relation to "providing clearing activities." The same rationale has to apply to the effectiveness of comparable barriers for independent account controllers.

In addition, the Commission's proposal will, in practice, require any financial entity that maintains separate business units (that are financial entities) and trades for various proprietary and customer accounts to aggregate its holdings across the various business units, which may be located in the U.S. or abroad.[33] The aggregation requirements under the Proposed Rules will require financial entities that may not have shared information in the past to disclose their positions to other independent trading operations of related financial entities in real time. For example, if the position limit is 1,000, two separate business units, which in the aggregate are under the position limit as one unit is long 1,100 and the other unit is short 100, must agree on any sale or purchase of additional futures contracts to ensure they both stay under the position limit and must coordinate their activities going forward. This is a highly inefficient and illogical outcome.

We also note that the aggregation of positions might create legal jeopardy for certain market participants, as aggregation would require the allocation of positions between separately controlled units and separate legal entities, requiring such persons to coordinate business plans, including trading activities and commercial hedging opportunities, in potential violation of contractual or legal obligations, such as Federal Energy Regulatory Commission ("FERC") affiliate rules, bank regulatory restrictions, antitrust provisions and, if applicable, their fiduciary duties as asset managers or advisers of discretionary accounts. We also believe that elimination of the independent account controller exemption for financial entities is inconsistent with well-established CFTC precedent, as well as the approach taken by the SEC under the Securities Exchange Act of 1934[34] and by FERC under Section 203 of the Federal Power Act permitting disaggregation of positions where the positions are independently controlled.[35] This provision could also require market participants to violate their fiduciary duty to customers by sharing confidential trading information with third parties, and could lead to anti-competitive activity, if two unrelated entities are required to share such confidential information.

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[32] Implementation of Conflicts of Interest Policies and Procedures by Swap Dealers and Major Swap Participants, 75 Fed. Reg. 71391 (November 23, 2010).

[33] The extraterritorial application of these rules wholly outside of the U.S. on, for example, foreign boards of trade, presents significant legal and policy issues.

[34] For example, the SEC will permit the parent holding company of qualified institutional investors to disaggregate the holdings of its various business units if there are appropriate informational barriers between the business units for purposes of Section 13(d) and (5) and Section 16(a) reporting requirements. *See* Amendments to Beneficial Reporting Requirements, Exchange Act Release No. 34-39538, 63 Fed. Reg. 2,854, at 2857-8 (Jan. 12, 1998).

[35] 18 C.F.R. § 33.1 (2009).

This problem is exacerbated if aggregate limits are applied intra-day as it requires real-time sharing of information that should never be shared at all. Assuming that there is no common control, the individual traders in different entities that are subject to aggregation may not (and should not) have real-time access to trading information from other traders with which they share an aggregated limit. To the extent that their independent actions (each of which should have a separate economic justification) create a position that exceeds the applicable limits, the overage is unintended and is extremely difficult to prevent without forcing an inappropriate degree of cooperation and information sharing. While it may be feasible to take a snapshot of the positions at the end of the day and issue instructions to the traders to reduce their positions as required, this cannot be done on a real-time basis. If the Commission intends to aggregate positions that would previously have been eligible for disaggregation, then it should clarify that the limits do not apply on an intra-day basis and it should allow a grace period for the affected traders to bring the overall position back into compliance.

Notably, the current independent account controller exemption differs from the Proposed Rules by allowing for procedures that "may provide for the disclosure of information which is reasonably necessary for an eligible entity to maintain the level of control consistent with its fiduciary responsibilities and necessary to fulfill its duty to supervise diligently the trading done on its behalf."[36] We believe that the Commission should adopt a similar exemption in its final rules for all entities relying on the independent account controller exemption to permit appropriate oversight.

We strongly recommend that the Commission retain the exception for independently controlled and managed accounts, and eliminate the needless and artificial distinction between financial entities and non-financial entities.

Clarify "Traders" and "Persons"

Proposed Rule § 151.7 uses the term "trader" and the term "person" in various places, which creates significant confusion and should be rectified by only using the term "trader" in all circumstances. In particular, it is not clear if these terms are intended to refer only to individuals, only to entities, or both, and how they will be applied in practice. First, the basic aggregation provision, in Proposed Rule § 151.7(a), requires aggregation of "all positions in accounts for which any trader" controls trading, and Proposed Rule § 151.7(b) extends this requirement to any account "in which the trader . . . directly or indirectly has a 10 percent or greater ownership or equity interest." It is unclear if these provisions are intended to apply to each individual managing accounts or to an entity that owns the accounts.

Second, the provision regarding the independent account controller exemption, which is set forth in Proposed Rule § 151.7(f), refers to "persons." Specifically, that provision states that an entity seeking to utilize the exemption from aggregation for independently controlled and managed accounts must demonstrate, *inter alia*, that its "owned non-financial entity's trading decisions are

[36] CFTC Rule § 150.3(a)(4)(i)(A).

controlled by *persons* employed exclusively by the owned non-financial entity, who do not in any way share trading control with *persons* employed by the entity" (emphasis added). Because a "trader" is defined in the Proposed Rules as "a person that, for its own account or for an account that it controls, makes transactions in referenced contracts or has such transactions made,"[37] we believe that use of the term "trader" in § 151.5(f)(2) would not change the substantive effect of the provision, and that the reference to "persons" rather than "traders" in that provision is needlessly confusing. Therefore, the Commission should eliminate any reference to "person" for purposes of the aggregation rules.

V. The Commission Should Not Adopt a Phase Two Position Limits Regime

We remain deeply concerned with the Phase Two limits and believe that they should not be adopted for several reasons: (1) with little or no data on the OTC commodity swaps markets, crafting appropriate limits on OTC swaps is currently impossible; (2) there is no evidence that excessive speculation exists nor that position limits would solve problems created by excessive speculation; (3) financially-settled contracts are not disruptive to the markets; and (4) the opportunity for excessive speculation or market manipulation in the outer months is dramatically lower than in the spot month.

With respect to the first point, as discussed above with respect to applying Phase One limits to the OTC swaps market, given that the Commission lacks information on the size of the market of the economically equivalent swaps of the 28 referenced commodities, we do not believe the Commission can properly develop a position limit regime to impose limits on these products. We believe the Commission should have a clear understanding of the size, volume, liquidity, and trading activity of these markets before considering imposing a position limit on them. In particular, imposing a limit of 10% of the first 25,000 contracts and 2.5% of the remainder on all enumerated commodities, is arbitrary, unsupported, and, we submit, subject to legal challenge. We reiterate Commissioner Sommers's statement in dissent of the Proposed Rules at the January Meeting: that the Proposed Rules are "flawed in a number of respects [and the CFTC] should conduct a complete analysis of the swap market data before [it] determine[s] the appropriate formula to propose." Furthermore, as Commissioner O'Malia stated during the January Meeting, the CFTC must collect market data so as to "ensure that [it] can see across all markets, and [that] legitimate hedging strategies are not negatively impacted by this [P]roposed [R]ule."

We appreciate that the CFTC shares our concerns with its lack of data on the OTC swaps markets, and proposed regulations in November 2010 to gather positional data on physical commodity swaps.[38] However, the Commission anticipates the collection of positional data will not begin until the third quarter of 2011, and we believe that the data gathered under this rule will be vital for the Commission to determine whether Phase Two limits are appropriate, and if so, to craft limits appropriate to address any documented problems in these markets. We see no basis

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[37] Proposed Rule § 151.2.
[38] Position Reports for Physical Commodity Swaps, 75 Fed. Reg. 67,258 (November 2, 2010) (to be codified at 7 C.F.R. pts. 15 and 20).

upon which the Commission can establish the structure of single-month and all-months-combined position limits across classes of commodities without the data on the size of the market and an analysis of speculation, implementation, liquidity and price discovery in that context. Therefore, we urge the Commission to separate the Phase Two position limits into a separate rulemaking process that can be taken up at such time as the Commission has the empirical data necessary to formulate appropriate limits, if in fact any are required.

With respect to the second point, as discussed in the Introduction, neither the Commission nor the Release has provided evidence that excessive speculation exists or that position limits would address problems created by excessive speculation.

With respect to the third point, we believe that Commission-established position limits in financially-settled contracts are not necessary, as explained in Section II. Market participants frequently use physical contracts as a proxy to broadly hedge their exposure to commercial risk. In many cases, there is no intention of making or taking delivery of the physical commodity. Such hedges can be problematic as one must eventually exit the physical futures position while trying to maintain the price protection in place for as long as possible so as to replicate the settlement price as closely as possible. This leads to large open interest in the physical contract that may be unstable for the market. The financial contract, however, has none of these concerns; it settles against the physical futures settlement. A party with a desire to hedge financial risk need not use a physical product, as it has access to a product that mirrors the risk that the counterparty desires to hedge. Imposing position limits on financially-settled contracts will restrict the ability of market participants to use financially-settled contracts to hedge their commercial risk, and will force many participants to use physically-settled contracts or the physical commodity instead. Imposing position limits on financially-settled contracts would thus drive market participants, many of whom never have any intention of making or taking physical delivery, to physically-settled contracts, thereby exacerbating the concerns accompanying physical contracts, or to the physical markets, which raises wholly separate issues that have not to date been adequately considered. For this reason, we believe that position limits on financially-settled contracts are in fact counterproductive and should not be imposed.

With respect to the fourth point, the opportunity for excessive speculation or market manipulation in the outer months is dramatically lower than in the spot month, thus rendering any limits in the outer months, as imposed by the single-month and all-months-combined limits, unnecessary and problematic. If market participants are limited in the positions they can hold across all months, they will concentrate their holdings in contracts near expiry to capitalize on the greater liquidity. This will both reduce liquidity in the outer months and increase volatility closer to expiration. As a result, this increases the price of hedging for commercial producers who are seeking to protect long-term price risk by trading in the outer months. For these reasons, we urge the Commission to separate the Phase Two position limits into a later rulemaking process that can be taken up at such time as the Commission has done the necessary analysis and has the empirical data necessary to formulate limits that are appropriate and tailored to meet its objectives.

We also note that, under the Proposed Rules, the non-spot-month position limits will be imposed on swaps not only with the same delivery location but also on swaps with delivery locations "with substantially the same supply and demand fundamentals, as that of any [core] referenced futures contract"[39]. If the Commission is to impose limits on swaps with delivery locations "with substantially the same supply and demand fundamentals," then as part of the information gathering process, the Commission needs to identify these locations, and then allow market participants the opportunity to review and comment. The Commission will also require this information to determine the volume of swaps at these locations in order to properly determine position limits.

Increased Limits

Noting that the single-month and all-months-combined position limits are not currently in place for energy and metals markets, the Release seeks comment as to whether the CFTC should consider setting limits initially on these commodities at some higher level, such as 10% of the first 25,000 contracts and 5% thereafter of open interest, "to best ensure that hedging activities or price discovery are not negatively affected."[40] While we question the basis for any of these limits, we believe that the CFTC should impose these higher position limits to ensure that hedging activities and the price discovery function of the commodity markets are not harmed by the imposition of the lower position limits set forth in the Proposed Rules. As discussed above, Section 737 of Dodd-Frank has multiple objectives and thus requires that the CFTC balance the goals of preventing excess speculation and market manipulation against preserving the ability of the markets to serve a price discovery function and to allow for *bona fide* hedging activity. Adopting position limits of 10% of the first 25,000 contracts and 5% thereafter is appropriate as they would better ensure liquidity and the price discovery function of the commodity markets than the lower limits of the Proposed Rules.

With regard to agricultural commodities, the Release seeks comment as to whether the current position limits should be retained, if the CFTC should impose the proposed position limit of 10% of the first 25,000 contracts and 2.5% thereafter (the "10%/2.5% Rule"), or the alternative position limits requested by the Chicago Board of Trade in an April 2010 petition to the Commission.[41] We note that the Release failed to provide any justification for proposing to retain the all-months-combined position limits for enumerated agricultural commodities in current CFTC Rule § 150.2. By retaining the current limit, the Proposed Rule would treat certain agricultural commodities contracts differently from other agricultural, energy and metal contracts and in doing so, would result in lower limits than would be imposed under the proposed 10%/2.5% Rule. We believe such an outcome would be contrary to the proposed rule recently issued by the CFTC that would eliminate any distinctions between agricultural swaps and options under Dodd-Frank.[42] Therefore, we support the position limits recommended by the Chicago

[39] 76 Fed. Reg. at 4768.
[40] 76 Fed. Reg. at 4759.
[41] CME Group Petition for Amendment of Commodity Futures Trading Commission Regulation (April 6, 2010), available at http://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/DF_26_PosLimits/index.htm.
[42] Commodity Options and Agricultural Swaps, 76 Fed. Reg. 6095 (Feb. 3, 2011).

Board of Trade, as we believe that they would better protect the liquidity and price discovery function of the agricultural commodity markets than the current limits. We believe that the imposition of the current limits for agricultural commodities under Phase Two would be disruptive to market participants, particularly if the independent account controller exemption is eliminated along with the risk management exemption, and the aggregation of limits across trading venues is imposed.

Calculation of Limits

Under the Proposed Rules, the CFTC would impose position limits on an annual basis, based on the open interest of the referenced commodity. Therefore, it will be essential for all market participants to have a clear understanding of the level of open interest and the estimated deliverable supply of the referenced commodity that will be used by the CFTC to generate the position limits. In order for this regime to be effective, the data used by the CFTC to generate the open interest and estimated deliverable supply statistics, and consequently the position limits, must be transparent and accessible by market participants, so they can properly anticipate the position limits and adjust their holdings to ensure orderly compliance with such limits. In addition, the calculations made by the CFTC must be replicable, to allow market participants to verify the calculation of the position limit imposed by the CFTC. We also believe that the structure of the position limit calculation is flawed, as traders will have to build in a cushion to stay below the position limits, thus lowering the open interest, leading to a lower position limit the following year, creating a cycle of lower open interest and lower position limits every year. In turn, this will make it very difficult to manage long-term risks, especially in the outer months, as that might require a trader to take a large position that would exceed the position limits. Market participants need flexibility and liquidity to manage their risks, even if that would require them to briefly hold a large or unhedged position.

Second, we question the basis for the Commission to apply an "estimated deliverable supply" calculation as the basis for spot-month limits in Phase Two. We are not aware, and the Commission has not identified, any connection between deliverable supply and spot-month potential manipulation or excessive speculation. Absent a factual basis, "estimated deliverable supply" should not be applied. Instead, we urge the Commission to take into account the various characteristics of each referenced contract, including the different settlement options, given that there are significant differences among the contracts for similar and even the same commodities. We note that the markets for commodity futures and swaps have evolved in such a way as to make it arbitrary to set a single spot-month limit based upon "estimated deliverable supply." Instead, the Commission should set the spot-month limit based on a complete understanding of the supply characteristics, commercial settlement and delivery practices for each referenced contract.

Third, we believe that the definition of "estimated deliverable supply" in the Proposed Rules is both vague and lacks transparency. Under the Proposed Rules, each DCM would be required to submit to the Commission by December 31st of each year an estimated deliverable supply for each physical delivery referenced contract, along with the methodology and statistical data used

to reach such estimate. By the following January 31st, the CFTC would be required to either rely on the DCM estimates or its own estimate of deliverable supply. However, the proposed definition of deliverable supply does not indicate the methodology that the Commission would use to determine whether to rely on DCM estimates nor, in the absence of such reliance, how the Commission will calculate its own estimates of deliverable supply. We urge the CFTC to provide additional information on how "estimated deliverable supply" will be calculated, at a minimum by explaining how various factors, such as production, storage, and/or alternate delivery options, will be measured in the calculation of the estimated deliverable supply.[43]

Moreover, we believe that the definition of estimated deliverable supply should incorporate a mechanism to reduce year-to-year volatility. Because the calculation of deliverable supply is performed independently each year by the Commission based on the DCM's estimate of deliverable supply, it is possible that the estimated deliverable supply, and, therefore, the position limits that rely on the calculation of deliverable supply, may fluctuate dramatically between any two years. The resulting volatility in the limits will be very problematic for those market participants with positions approaching the position limits in those years in which the limits are adjusted downward by the CFTC, as a result of the decreased estimates of deliverable supply. It will be difficult for market participants to reduce their positions quickly enough to stay within the position limits, without disrupting their portfolio or the markets, especially between years in which deliverable supply experiences particularly large fluctuations. The Commission should modify the proposed definition of deliverable supply to reduce the possible year-to-year volatility in the spot-month limits, and we suggest that the Commission calculate estimated deliverable supply using a five-year rolling average. This would smooth out any short-term volatility in the estimated deliverable supply.

As we have stated in the January 2011 and April 2010 Comment Letters, respectively, we urge the CFTC to provide the calculations, back-up data to the calculations ("month-end" numbers), cross-reference tables to original source data, details of manipulation of original source data, and daily historical data, to all market participants in a timely manner so that participants can properly understand, and structure their businesses to comply with the position limits. In addition, the CFTC must provide this information to market participants well before the position limits are imposed and reset on an annual basis, to ensure market participants have enough time to adjust to the new limits, without disrupting the markets.

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[43] In our January 2011 Comment Letter, we encouraged the Commission to use "available deliverable supply" as the basis for its determination of the actual position limits. Available deliverable supply is supply that can be made readily available for delivery under contract terms, and we believe this definition provides a more accurate benchmark for setting position limits than the "estimated deliverable supply." The Commission has noted in prior administrative decisions that "available deliverable supply" is measured over the period in which a market participant can procure a commodity with "prudent planning," and such supply includes (1) all available local supply, (2) all deliverable non-local supply, and (3) all comparable supply (based on factors such as product and location). Available deliverable supply should also include contracts that are subject to long-term commitments, which are subsequently made available to trade in the market.

Netting

The Proposed Rules permit the netting of positions for like referenced contracts within each applicable position limit. While we agree, in principal, with these netting provisions, we believe that the proposed netting provisions must be modified, to prevent the unnecessary and harmful loss of market liquidity. Market participants use swap dealers as intermediaries across a variety of commodity markets, which allows swap market participants to effect hedging strategies that are designed to reduce their commercial risks. In addition, swap dealers allow market participants to hedge particular commercial risks (*e.g.*, the price of jet fuel), which they otherwise would be exposed to, given the lack of correlated jet fuel contracts. To provide these services, swap dealers have typically used long and short positions, netted across all of their counterparties, to hedge their exposures. To allow swap dealers to continue to perform these services to market participants, we believe the Commission must revise the netting provisions of the Proposed Rules.

First, the Commission should allow netting across classes, *i.e.*, between swaps positions and futures positions. At the January Meeting, Commissioner O'Malia noted that he was concerned that the class limits provision in the Proposed Rules prohibited netting across the futures and swaps markets once a trader reaches a certain level, given that once a trader reached the class limits in the futures market, their position could not be offset by an opposite position in the swap markets. We share his concerns, as netting between swaps and futures is necessary to accurately reflect the true positions that market participants hold in the market. An inability to net would impede the ability of participants in one market from utilizing the liquidity in the other, ultimately reducing liquidity in both markets and raising the costs of hedging for all market participants, including end-users. In order to facilitate netting, the Commission should ensure that the concept of "economically equivalent" derivatives covers contracts whose correlation with futures can be established through accepted models that address features such as maturity, payout structure, locations basis, product basis, etc. Therefore, we urge the Commission to ensure that the Proposed Rules will permit market participants to net across their positions in the swaps and futures markets for purposes of the class limits and the aggregate limits.

Second, we are concerned that the Proposed Rules do not address the issue of whether market participants can net across commodities, *i.e.*, whether they can hedge one commodity with another. We strongly believe that the Commission should allow netting across commodities when contracts in those commodities are sufficiently correlated. Permitting cross-commodity netting is vital for the netting regime to reflect accurately the actual hedging practices utilized by market participants. Market participants commonly hedge one commodity with another commodity, or even with baskets of other commodities, such as using a mix of 50% crude oil and 50% heating oil to hedge jet fuel. Prohibiting netting across commodities would severely limit the ability of market participants to hedge effectively and would unnecessarily restrict market liquidity. The CFTC should permit cross-commodity netting, using either a bright line test where netting is allowed so long as the correlation of the contracts is above a certain level, such as 75%, or using a pro rata formula where cross-commodity netting is permitted to the extent of the correlation between them.

Finally, we believe that the class limits should be higher than the aggregate limits because a trader's speculative position depends upon the net size of its position, not upon whether such position consists of futures or of swaps. Under the Proposed Rules, the aggregate position limit is the futures or swaps class limits. This approach is problematic because it is likely to limit a trader's activity in futures or swaps, even if its net speculative position remains well below the aggregate limit. Given that the stated justification for position limits is a desire to curtail the perceived threat of excessive speculation and manipulation in the market, the position limits should focus on limiting a trader's aggregate exposure to the market; limiting this exposure would be best achieved by limiting the aggregate position held by a market participant, not the specific types of contracts of which the position consists. Rather than using the 10%/2.5% formula for each of the class and aggregate limits, we believe that the Commission should increase the class limits so as to allow a trader sufficient flexibility to choose whether to hold futures positions or swaps positions on a net basis within the aggregate limits.

VI. Movement of Markets and Market Participants Off-Shore

Section 4a(a)(2)(C) of the CEA, as amended by Section 737 of Dodd-Frank, requires the CFTC to "strive to ensure that trading on foreign boards of trade in the same commodity will be subject to comparable limits and that any limits to be imposed by the Commission will not cause price discovery in the commodity to shift to trading on the foreign boards of trade." As Commissioner Sommers noted at the January Meeting, "This proposal does not contain any analysis of how the proposal attempts to accomplish this goal. In fact, the proposal does not even mention this goal. Driving business overseas is a long standing concern of mine, and that concern remains unaddressed." We concur, and we believe that the Proposed Rules will likely result in market participants, especially those that operate outside the U.S., shifting their trading activity to non-U.S. markets.

Commissioner Dunn also noted at the January Meeting that if the CFTC determines that position limits are appropriate, "we must then work with our sister regulators around the globe to ensure that limits set here in US markets, are not simply evaded by trading in other venues around the world." As noted in ISDA's April 2010 Comment Letter, we remain deeply concerned that the imposition of position limits in U.S. markets regulated by the CFTC without comparable position limits on foreign markets would have the effect of driving trading to unregulated markets or foreign exchanges. That would reduce liquidity in the U.S. commodity markets, thereby increasing price volatility and hampering price formation in the U.S. commodity markets. We strongly urge the CFTC to work with foreign regulators to ensure that foreign commodity market participants are subject to position limits that are comparable to those imposed on U.S. market participants. As Commissioner Sommers noted, "While the EC is, for the first time, considering the use of position limits, there are fundamental differences from the CFTC's approach. In general, the EC has proposed only to give EU national regulators the option of setting position limits, and has suggested that it possibly may require limits only for agricultural commodities." Therefore, we believe that adoption of a permanent position limit regime should be postponed until the Commission has fully consulted with its counterparts around the globe about

harmonizing limits and phasing them in simultaneously, so as to ensure that position limits imposed on U.S. markets do not shift business offshore.

VII. Conclusion

The imposition of position limits of any kind are not supported by the legally required analysis of necessity and appropriateness. Thus, we recommend against the adoption of any limits until such an analysis establishes a legal basis for limits. Furthermore, we urge the Commission to refrain from imposing position limits unless and until its foreign counterparts impose comparable position limits on non-U.S. commodity markets, as raised by Dodd-Frank. If the Commission does adopt the Proposed Rules, we believe that substantial changes should be made to the proposed position limit regime to achieve the Commission's objectives without unnecessarily disrupting or limiting the commodity markets. In Phase One, the Commission should revise the provisions in the Proposed Rules regarding cash-settled contracts and should defer application of Phase One to OTC swaps. In addition, in Phase One the Commission should provide broad hedge and other exemptions from the position limits and recognize that financial counterparties should have the benefit of exemptions from the aggregation of positions. For the Phase Two limits, we urge the Commission to impose higher limits on the referenced commodities, to permit the netting of contracts across classes and contracts, and to provide other important clarifications of the Proposed Rules. However, without significant modifications to both Phase One and Phase Two of the proposed position limit regime, the Proposed Rules will disrupt the liquidity and price discovery function of the markets. Finally, we urge the Commission to provide a robust cost-benefit analysis of the imposition of the Proposed Rule on all market participants.

We appreciate the opportunity to provide these comments and stand ready to provide any assistance in this process that might be helpful to the Commission.

Sincerely,

Robert Pickel
Executive Vice Chairman

Kenneth E. Bentsen, Jr.
Executive Vice President
Public Policy and Advocacy