February 10, 2014

Ms. Melissa Jurgens
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW.
Washington, DC 20581

Re: Notice of Proposed Rulemaking – Position Limits for Derivatives (RIN 3038-AD99)

Dear Ms. Jurgens:

The International Swaps and Derivatives Association, Inc. ("**ISDA**")[1] and the Securities Industry and Financial Markets Association ("**SIFMA**")[2] appreciates the opportunity to provide the Commodity Futures Trading Commission (the "**CFTC**" or "**Commission**") with comments and recommendations regarding the Notice of Proposed Rulemaking for Position Limits for Derivatives (the "**Proposal**").[3] In submitting this letter, we also reference and re-incorporate the previous comments we have submitted to the Commission (our "**Previous Comments**")[4] with

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1 ISDA's mission is to foster safe and efficient derivatives markets to facilitate effective risk management for all users of derivatives products. ISDA has more than 800 members from 58 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 provides. 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, DC, is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

3 Position Limits for Derivatives, 78 Fed. Reg. 75680 (Dec. 12, 2013).

4 See, for example, our letters dated January 11, 2011 (available on ISDA's website at: http://www.isda.org/speeches/pdf/CFTC-Position-Limits-Pre-Comment.pdf); March 28, 2011 (available on the Commission's website at: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=33568); and January 17, 2012 (available on the Commission's website at: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=50066).

respect to the CFTC's prior effort to impose position limits across futures and swaps (the "**Original Position Limit Rules**").[5]

The Proposal would impose speculative position limits on futures and option contracts in 28 energy, metals, and agricultural commodities ("**core referenced futures contracts**") and their economically equivalent swaps (collectively, "**referenced contracts**"), pursuant to Section 4a(a) of the Commodity Exchange Act (the "**CEA**"),[6] as amended by Section 737 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**" or the "**Dodd-Frank Act**").[7] The Proposal also contains provisions that would exempt certain *bona fide* hedging positions from the position limits.[8]

Overview

Consistent with the rationale noted in our Previous Comments, we remain deeply concerned with many aspects of the new Proposal, and we continue to challenge the fundamental premise upon which the CFTC argues that it has authority to impose position limits under Dodd-Frank. For these reasons, and based on the concerns identified in this letter and in our Previous Comments, we do not believe that the Commission should go forward with the Proposal until such time as it is able to demonstrate that the statutory pre-requisites to imposing position limits have been satisfied, and until such time as the Commission has meaningfully evaluated the costs and benefits of the rules it intends to impose.

This comment letter is organized into two sections—a legal analysis of the Proposal in the context of the CFTC's statutory position limits authority, and comments on the substantive provisions of the Proposal.

In our comments assessing the legal sufficiency of the Proposal, we first explain that the Commission has again misinterpreted and misapplied the Dodd-Frank amendments to the CFTC's position limits authority. Congress has not mandated that the Commission impose position limits. Instead, Congress has unambiguously directed the Commission to meet a series of standards and to make specific determinations of necessity and appropriateness prior to exercising its position limits authority. Second, we challenge the adequacy and relevance of the Commission's proposed "necessity finding," which it has offered as an alternative to its summary conclusion that CEA Section 4a(a) constitutes an unqualified mandate to impose position limits. The evidence presented in the existing rulemaking record, including the two case studies proffered by the Commission in its "necessity finding" does not support the position limits regime set forth in the Proposal, particularly in light of the Commission's failure to define

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5 Position Limits for Futures and Swaps, 76 Fed. Reg. 71626 (Nov. 18, 2011), vacated, ISDA v. CFTC, 887 F. Supp. 2d 259 (D.D.C. 2012).

6 7 U.S.C. § 6a(a) (2012).

7 Pub. L. No. 111-203 (2010).

8 The Commission proposed aggregation rules in a separate rulemaking, Aggregation of Positions, 78 Fed. Reg. 68946 (Nov. 15, 2013), that is not addressed in this comment letter.

excessive speculation. Third, we demonstrate that the Commission has again failed, as it did when proposing the Original Position Limit Rules, to provide any meaningful consideration of the costs and benefits of its proposed rulemaking.

As a consequence of these legal deficiencies, we urge the CFTC to postpone adoption of the Proposal until *after* it has collected, analyzed, and presented the data needed to satisfy the standards set forth by Congress in delineating the CFTC's statutory position limits authority. After reviewing such data,[9] which should be collected to establish a relevant, current, and forward-looking record, the Commission should then re-propose position limits, for public comment, but only to the extent that it can demonstrate and determine that: (1) in conjunction with providing a definition of excessive speculation, harmful excessive speculation exists or is reasonably likely to occur with respect to particular commodities; (2) position limits are "necessary" and "appropriate" to "diminish, eliminate, or prevent" the burden on interstate commerce caused by such excessive speculation in the markets for those particular commodities; and (3) the imposition of position limits and the levels of the limits imposed by the Commission are appropriate in each market and for each commodity for which such limits would apply.

Should the Commission determine to go forward with the Proposal, we believe that substantial changes must be made to achieve the Commission's and Congress's objectives without unnecessarily harming or disrupting commodity markets and market participants. In our comments on the substantive provisions of the Proposal, we specifically argue that the Commission should abandon those aspects of the Proposal that would impose position limits outside of the spot month. We urge the CFTC to consider, as an alternative to its Proposal, the many tools at its disposal to address concerns related to excessive speculation in a manner that would be less harmful than the position limits set forth in the Proposal, which would impose significant, immediate, and unjustified costs on markets and market participants. The CFTC's consideration of proposed alternatives, such as those we identify below, is compelled by both the CEA's requirement that the Commission determine that limits are "appropriate" and by general rulemaking requirements under the Administrative Procedure Act (the "**APA**").

Our comments further highlight the absence of evidence supporting the necessity and "appropriate[ness]" of position limits in the context of cash-settled contracts. We note that the Proposal for position limits in the spot month relies on a methodology that is both arbitrary and unjustified. We highlight concerns about unnecessarily limiting the scope of permissible netting, and we outline the problems the CFTC would create if it finalized the Proposal without first seeking to harmonize its efforts with non-domestic regulators. We also request that the Commission modify the proposal to use a harmonized definition of eligible affiliate, to not require netting of physical positions across affiliates when not appropriate, to not include trade options, to provide for a workable compliance period in the event the Commission does adopt final position limit rules, to provide certainty with respect to the contracts covered by the

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9 With respect to data, ISDA also believes that it is vital that the Commission clearly identify the data that it has evaluated and relied upon in reaching any conclusion to propose position limits, and the CFTC should make such data available to market participants during a public comment process so that the CFTC's analysis is susceptible to meaningful comment.

proposed limits, and to exempt SEFs from the requirements to set SEF-based position limits during the developmental phases of these markets.

With respect to the bona fide hedging provisions of the Proposal, we stress that the CFTC should include, as part of any final rule addressing position limits, a formal process for market participants to seek either a non-enumerated bona fide hedging exemption or an exemption pursuant to the Commission's general position limits exemptive authority. We also request that the scope of recognized or enumerated hedging exemptions in any final rule include the full scope of anticipatory hedging activities, activities related to unfilled storage capacity, and other related hedging practices relied upon by market participants in the operation of their commercial businesses. Finally, we request that the Commission not adopt an unnecessarily restrictive standard for assessing compliance with the orderly liquidation requirement, and we urge the Commission to fully evaluate ways to mitigate the burdens and costs associated with the proposed reporting requirements applicable to claiming a bona fide hedge exemption.

I. Review of the CFTC's Statutory Position Limits Authority—CEA Section 4a

Under the Dodd-Frank amendments to the CEA, the statute is clear that the Commission, before imposing position limits, must consider both whether position limits are necessary and whether they are appropriate. If the Commission finds that position limits are necessary and appropriate for any particular commodity, the Commission is required to impose such limits. The Commission unambiguously cannot impose position limits with respect to a particular commodity until it has determined that position limits are necessary and appropriate with respect to that commodity. A missing or inadequate necessity or appropriateness finding, or a blanket finding of necessity and appropriateness that does not address each commodity to which the limits will apply, is insufficient to allow CFTC-imposed position limits under the CEA. Finally, in addition to the requirement to establish the necessity for and appropriateness of position limits, the CFTC has detailed requirements to consider the costs and benefits of the Proposal through a meaningful analysis of the impact—both direct and indirect—that position limits will have on commodities markets, market participants, and the economy generally.

A. CEA Section 4a Requires The Commission To Find That Position Limits Are Both Necessary And Appropriate For A Specific Commodity Before Imposing Such Limits

The position limit provisions in the CEA, first included by Congress as part of the initial adoption of the statute in 1936,[10] have never imposed an unqualified mandatory rulemaking obligation on the CFTC. Since the CEA's adoption, the CFTC has been required to find that position limits are "necessary" before imposing them. The Dodd-Frank amendments to CEA Section 4a(a), while it did direct the CFTC to examine the imposition of CFTC controlled position limits, did not change the statute's clear directive that, prior to implementing a position limits regime, the CFTC must establish an evidentiary record to establish the need for the limits to be adopted.

[10] Commodity Exchange Act of 1936, Pub. L. No. 74-675, 49 Stat. 1491.

As we outlined in our Previous Comments, Section 4a(a)(1) of the CEA, as amended by Dodd-Frank, 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 that are not traded on a DCM or SEF but perform or affect a significant price discovery function ("**SPDF**")[11] with respect to regulated entities, only if the Commission finds that such limits "are necessary to diminish, eliminate, or prevent" the burden of excessive speculation in the markets for particular commodities. The clear and unequivocal meaning of this provision, therefore, is that position limits may be imposed only if the CFTC has determined that "excessive speculation" exists and that position limits for the commodities at issue are "necessary" to address that condition. Section 4a(a)(2) of the CEA authorizes the CFTC to "establish limits on the amount of positions, as appropriate," and "in accordance with the standards set forth in [Section 4a(a)(1)]", that a person may hold with respect to futures or options contracts traded on or subject to the rules of a DCM. Therefore, any position limit regime must also be "appropriate" to the achievement of the statutory objective of addressing "excessive speculation."

Further, Section 4a(a)(5) of the CEA authorizes aggregate position limits, again only "as appropriate," for swaps that are economically equivalent to DCM futures and option contracts with CFTC-imposed position limits. Similarly, 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 SEF contract and made available from within the United States via direct access; and (3) SPDF swaps (including OTC swaps).

Section 4a(a)(3) of the CEA establishes general constraints on 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."

Prior to Dodd-Frank, the CFTC had the authority, but not the obligation, to adopt position limits. The CFTC's authority to promulgate such limits was conditioned on a finding that the limits were "necessary." Under the amended CEA, the CFTC is required to consider whether position limits are "necessary" and "appropriate" for all physical, non-excluded commodities and then *must* adopt such limits if—and only if—it finds that limits are both "necessary" and "appropriate" as to a particular commodity. Nothing in the text of Dodd-Frank, nor in the legislative history supporting the adoption of the Dodd-Frank Act, converts the nature of the CFTC's position limits authority into the unqualified mandate claimed by the Commission, regardless of whether position limits are necessary or appropriate.[12] On the contrary, in the

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[11] See 7 U.S.C. § 6a(a)(4) (providing guidance on when a swap performs a significant price discovery function, based on price linkage, the possibility of effective arbitrage, price reference, liquidity, and other factors).

[12] To be clear, we agree that the amendments to the CEA in the Dodd-Frank Act are not a mere affirmation of the Commission's pre-existing discretionary authority to impose position limits.

Dodd-Frank amendments to the CFTC's position limits authority, which generally expanded that authority to encompass swaps, Congress consistently qualified the CFTC's position limits authority with the limiting language outlined above. In each instance, the statutory language that the Commission asserts as imposing on it a "mandatory" obligation to adopt position limits incorporates and is limited by significant and meaningful qualifying language that requires both necessity and appropriateness findings. Simply, the Dodd-Frank amendments require the Commission to consider limits, applying specific statutory criteria; the amendments do not require that limits be adopted unless those limits are both necessary and appropriate.

1. The CFTC has Ignored Congress's Express Requirements in the Dodd-Frank Amendments to CEA Section 4a

Instead of requiring that the Commission blindly impose position limits, Section 4a imposes several responsibilities that the CFTC must fulfill before it imposes limits—none of which, as we will discuss in detail below, has been satisfied by the evidence cited by the Commission to support the current Proposal.

CEA Section 4a(a)(2) permits the CFTC to establish limits with respect to derivatives on physical commodities "[i]n accordance with the standards set forth in [Section 4a(a)(1)]."[13] Section 4a(a)(1) in turn provides that the CFTC may only fix position limits "as the Commission finds are necessary" for the purpose of "diminishing, eliminating, or preventing" the "undue and unnecessary burden on interstate commerce" of "[e]xcessive speculation in [contracts on] any commodity . . . causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity."[14]

The Commission insists that the term "standards" as used in Section 4a(a)(2) refers only to the aggregation rules and "flexibility" standards in Section 4a(a)(1), which the Commission defines as the authority to impose different limit levels for different commodities, markets, and transactions.[15] This interpretation is unmoored from Section 4a(a)(1)'s text, which nowhere indicates that the "standards" referred to in Section 4a(a)(2) are limited to the aggregation and flexibility provisions. In any event, even if the Commission were correct that "standards" refers only to aggregation and flexibility standards (and we do not believe that is a permissible reading of Section 4a(a)(2)), that would not establish that the use of the word "standards" in Section 4a(a)(2) *repeals* any remaining aspects of Section 4a(a)(1); i.e., Section 4a(a)(1) and the necessity finding requirement would continue to apply on their own terms even if they had not been incorporated into Section 4a(a)(2). To ignore the import of the phrase "[i]n accordance

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Rather, the amendments require, for the first time, that the CFTC must consider whether limits are necessary and appropriate for all physical, non-excluded commodities, and must impose limits for those commodities for which the CFTC properly determines that limits are both necessary and appropriate.

13 7 U.S.C. § 6a(a)(2)(A).

14 Id. § 6a(a)(1).

15 Position Limits for Derivatives, 78 Fed. Reg. 75680, 75683 (Dec. 12, 2013).

with the standards set forth in [Section 4a(a)(1)]" and to conclude, as the Commission does, that it must impose position limits without giving weight to the extensive necessity language in 4a(a)(1) contradicts the plain text of the Dodd-Frank amendments.

In contrast to the Commission, we interpret the CEA, as we always have, as providing that the Commission is unambiguously required to make necessity findings before implementing position limits.[16]

Moving beyond the necessity standard of Section 4a(a)(1), position limits may also be established under Section 4a(a)(2) only "as appropriate."[17] Section 4a(a)(5), which addresses setting limits for economically equivalent swaps, also permits such limits to be established only "as appropriate."[18] That phrase "as appropriate," construed in the context of the statutory provisions and the CFTC's conditional authority to impose position limits, must be read to qualify the phrase "shall . . . establish," "shall set limits," and "shall establish"—meaning that the CFTC may establish position limits only if it finds that they are "appropriate" to the achievement of the statutory objectives. "As appropriate" cannot mean, as the CFTC contends, simply that the level of the limits must be "appropriate."[19]

In vacating the Original Position Limit Rules, which the Commission adopted pursuant to the same legal interpretation it relies on for the Proposal, the United States District Court for the District of Columbia (the "District Court") explained that the CFTC "fail[ed] to offer any compelling authority for its argument" that Congress intended the phrase "as appropriate" to refer to the actual levels of position limits—instead of referring to the more general

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16 We understand that the CFTC believes that it has used its "experience and expertise" to interpret the "ambiguities" of CEA Section 4a(a) as a "mandate that the Commission impose position limits." 78 Fed. Reg. at 75681. As explained above, there are no such ambiguities and the Commission's interpretation violates the clear statutory text. Even if ambiguity did exist, moreover, the Commission's interpretation requires such a strained and improper reading of the statute, and an active disregard for the provisions we highlight in this letter, that it cannot be given any deference. See id. at 75841 (O'Malia, Comm'r, dissenting) ("[T]he proposed rule now hides behind *Chevron* deference and invokes the Commission's 'experience and expertise' in order to justify setting position limits without performing an ex ante analysis using current market data." (citing id. at 75681–82, 75685, 75688, 75729)).

17 7 U.S.C. § 6a(a)(2).

18 Id. § 6a(a)(5).

19 Beyond Congress's intent that position limits not imperil important market functions, English grammar counsels against the CFTC's interpretation: Specifically, "as appropriate" is here an adverbial and thus appropriately qualifies one or more adjectives or verbs—e.g., "shall . . . establish"—rather than nouns. See Randolph Quirk et al., A Comprehensive Grammar of the English Language 52, 557–58 (1985). Congress would have used the adjective "appropriate" alone (i.e., "appropriate limits"), if it had intended for "appropriate" to modify the object, "limits on the amount of positions," in Section 6a(a)(2).

determination to adopt position limits at all.[20] In the Proposal, the CFTC does not offer any new authority for re-affirming its interpretation that the phrase "as appropriate" only refers to the level of limits to be proposed.[21] Instead, the Commission again defers to its faulty conclusion that because "CEA section 4a(a) mandate[s] the imposition of limits, the words 'as appropriate' must refer to the level of limits . . . ."[22]

By failing to comply with Congress's direction to set position limits "as appropriate," and by continually appealing to its unreasonable conclusion that the Dodd-Frank amendments to 4a(a) constitute an unqualified mandate, the Commission has once again ignored the unambiguous language of the statute requiring the CFTC to find that limits are necessary and appropriate before imposing them. The Commission's unsubstantiated references to "experience and expertise" do not satisfy the Commission's legal obligations to determine the necessity for and appropriateness of limits.

Similarly, CEA Section 4a(a)(2) requires the CFTC to "strive to ensure that . . . any limits to be imposed by the Commission will not cause price discovery in the commodity to shift to trading on the [FBOTs]."[23] Under the Proposal, the CFTC "would apply position limits to positions on [FBOTs] provided that [such] positions are held in referenced contracts that settle to a referenced contract and that the FBOT allows direct access to its trading system for participants located in the United States."[24] However, the CFTC does not provide any analysis, although required to do so under the statute, or attempt to review any evidence, as to whether the position limits set forth in the Proposal would cause price discovery to shift to trading on FBOTs.[25]

CEA Section 4a(a)(3) provides that the CFTC must evaluate four considerations, in addition to necessity and appropriateness with respect to particular commodities, when it seeks to impose position limits. If the CFTC seeks to adopt position limit rules, therefore, it *must* consider whether the position limits will (1) diminish, eliminate, or prevent excessive speculation; (2) deter and prevent market manipulation, squeezes, and corners; (3) ensure sufficient market liquidity for bona fide hedgers; and (4) ensure that the price discovery function of the underlying

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20 ISDA v. CFTC, 887 F. Supp. 2d 269, 276 (D.D.C. 2012) ("In its Opposition . . . , the CFTC relied on the Rule of Last Antecedent . . . as support for its construction of the 'as appropriate' language. . . . The CFTC's argument, however, is wrong for at least two reasons." (citation omitted)).

21 See 78 Fed. Reg. at 75681–85.

22 Id. at 75685 n.59.

23 7 U.S.C. § 6a(a)(2)(C).

24 78 Fed. Reg. at 75766.

25 Compare Position Limits for Futures and Swaps, 76 Fed. Reg. 71626, 71659 (Nov. 18, 2011), vacated, ISDA v. CFTC, 887 F. Supp. 2d 259 (D.D.C. 2012) (defending the CFTC's failure to estimate whether the Original Position Limit Rules would cause a shift to FBOTs by noting "it is difficult to attribute changes in the competitive position of U.S. exchanges to any one factor"), with 78 Fed. Reg. at 75758–81 (omitting any such discussion).

market is not disrupted.[26] These statutory constraints on the CFTC's exercise of its CEA Section 4a(a)(2) authority (*i.e.*, the six required statutory considerations in CEA Sections 4a(a)(2)(C) and 4a(a)(3)(B), the "standards" of CEA Section 4a(a)(1), and the need to address the "as appropriate" language throughout CEA Section 4a) demonstrate that Congress intended promulgating speculative position limits under CEA Section 4a(a)(2) to be a careful exercise that is attentive to the necessity, justification, and consequences of the Commission's action.[27]

In 1981, the CFTC adopted a rule that the CFTC describes as "requir[ing] the exchanges to establish position limits on all futures contracts, regardless of the characteristics of a particular market."[28] The CFTC's attempt to rely on this rulemaking from over 30 years ago to either eliminate or reduce its statutory burden to make a satisfactory necessity finding[29] is unavailing. However interpreted, the rulemaking does not reduce the scope of the CFTC's statutorily required necessity finding in any way, because the rulemaking has not been adopted by Congress and no longer even reflects the policies of the Commission.

In addition, the CFTC has not consistently followed the 1981 rulemaking's policy of directing exchanges to set position limits "regardless of the characteristics of a particular market." Beginning in the 1990s, the CFTC implicitly concluded "that position limits *were not necessary*" for some exchanges.[30] And in 2001, the CFTC made this conclusion explicit in codified guidance to exchanges: "In general, position limits are not necessary for markets where the threat of excessive speculation or manipulation is nonexistent or very low."[31] The CFTC thus cannot plausibly claim that the 1981 rulemaking provides any level of meaningful instruction to the interpretation of CEA Section 4a(a), as amended by the Dodd-Frank Act. Rather, the CFTC's appeal to the 1981 rulemaking is one in a series of ad hoc justifications for its failure to adhere to the requirements of the statute with regard to exercising its position limits authority.[32]

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26 7 U.S.C. § 6a(a)(3); see also 78 Fed. Reg. at 75841 (O'Malia, Comm'r, dissenting) ("[T]he Commission must also, in establishing any limits, ensure that there is sufficient market liquidity for hedgers and prevent disruption of the price discovery function of the underlying market.").

27 See Abbott Labs. v. Young, 920 F.2d 984, 988 (D.C. Cir. 1990) ("The 'reasonableness' of an agency's construction depends on the construction's 'fit' with the statutory language as well as its conformity to statutory purposes.").

28 78 Fed. Reg. at 75683 n.34 (citing Establishment of Speculative Position Limits, 46 Fed. Reg. 50938, 50940 (Oct. 16, 1981)).

29 See id. at 75683–84.

30 ISDA v. CFTC, 887 F. Supp. 2d 269, 273 n.5 (D.D.C. 2012).

31 Id. (quoting A New Regulatory Framework for Trading Facilities, Intermediaries and Clearing Organizations, 66 Fed. Reg. 42256, 42280 (Aug. 10, 2001) (codified at 17 CFR pt. 38 app. B)).

32 Another ad hoc justification that the CFTC revisits in its proposal is the existence of deadlines in Section 4a(a)(2). See 78 Fed. Reg. at 75682–83. But as the District Court noted, "This interpretation renders other parts of Section [4a] surplusage." ISDA, 887 F. Supp. 2d at 279. Further, "[a]n order by Congress to consider a matter expeditiously is not a mandate to be arbitrary capricious, irrational or sloppy" and still requires that the Commission's conclusions be

Congress could have chosen to speak directly and clearly to require, without the repeated qualifications described above or first requiring a necessity or appropriateness finding, that the CFTC impose position limits across futures, options, and swaps. But that is not the language Congress adopted in the Dodd-Frank Act amendments to CEA Section 4a(a).

2. A Supporting Record Is Required

As noted above, the CFTC is required to find that position limits are necessary and appropriate before imposing them on specific commodities. As recognized by Congress in the express qualifying language in the statute, the imposition of position limits is inherently an exercise that requires consideration of multiple variables. For example, implementing a position limits regime requires an evaluation of (i) whether "excessive speculation" exists in a particular market, (ii) whether position limits will be effective in addressing any excessive speculation and the appropriate level of limits that would do so, (iii) the commodities to be subject to the limits, (iv) whether limits should apply in the spot month or in all months, and so forth.[33] The sheer scope of variability that must be considered in exercising the CFTC's position limits authority precludes any interpretation that the statute constitutes an unqualified mandate to adopt limits.

Rather, we believe that the reason for the significant qualifying language included by Congress in adopting Dodd-Frank amendments to the CFTC's position limits authority is Congress's intent that the Commission *consider* whether to move from the existing paradigm—CFTC-set limits for nine agricultural commodities, exchange set position limits for other commodities[34]—to new, Commission-administered position limits for certain physical, non-excluded commodities, and impose those limits only where it determines that such limits are both necessary and appropriate. That directive naturally requires the CFTC first to develop a record indicating that (i) excessive speculation persists despite exchange set limits, as applied to the specific commodities to which that threat exists; (ii) such excessive speculation constitutes a burden; and (iii) position limits would be curative of such burden. Only after establishing this record for the specific commodities at issue can the Commission justify the exercise of its position limits authority. However, by committing to an unqualified reliance on its interpretation that position limits are

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based "on consideration of salient factors and . . . grounded in substantial evidence in the record." P.R. Mar. Shipping Auth. v. Fed. Mar. Comm'n, 678 F.2d 327, 336–37 (D.C. Cir. 1982).

33 See 78 Fed Reg. at 75841 (O'Malia, Comm'r, dissenting) ("As I have consistently stated, the Commission must perform a rigorous and fact-based analysis in order to determine whether position limits will effectively prevent or deter excessive speculation."). As the CFTC acknowledges, before each order imposing position limits on products that was issued by the Commodity Exchange Commission (the "CEC"), the CFTC's predecessor agency, the CEC undertook targeted factual inquiries and review of public comments and conducted hearings that focused on particular agricultural products. Id. at 75683.

34 Establishment of Speculative Position Limits, 46 Fed. Reg. 50938, 50939 (Oct. 16, 1981) ("When the [CEA] is read as a whole, it is apparent that Congress envisioned cooperative efforts between the self-regulatory organizations and the Commission. Thus, the exchanges, as well as the Commission, have a continuing responsibility in [the matter of position limits] under the Act."); see 17 C.F.R. §§ 150.2, 150.3 (2011).

mandatory, the CFTC has determined not to develop any record to support the need for change in the existing, and largely exchange-driven, position limits regime applicable to the commodity derivatives markets. Demonstrating the absence of a sufficient record, the CFTC has not even defined or identified excessive speculation,[35] has not demonstrated that the exchange-set limits are failing to work as intended or to prevent excessive speculation,[36] and has not established any evidentiary record upon which to conclude that it should assume direct responsibility over position limits from the exchanges, or that it would be effective in exercising such responsibility.

In sum, to support the legal sufficiency of the Proposal, the CFTC continues to rely on its incorrect conclusion that the Dodd-Frank amendments to CEA section 4a(a) amounted to an unqualified mandate that the Commission impose position limits. In contrast, the statute unambiguously identifies standards that the CFTC must follow when it purports to exercise its position limits authority. Yet in every instance, whether with respect to the requirement of a necessity finding, a determination of appropriateness, or even in defining the core term "excessive speculation," the Commission ignores Congress's instruction and instead defaults to its incorrect interpretation of the statute. No plausible interpretation of CEA section 4a(a) permits the CFTC to disregard the instruction of Congress in this way.

B. As an Ad Hoc Alternative to its Statutory Misinterpretation, the CFTC Proffers an Inadequate and Irrelevant "Necessity Finding"

Recognizing the assailable flaws in its argument that the CEA imposes an unqualified mandate to impose position limits, the CFTC Proposal includes a proposed finding that position limits are necessary under the statute.[37] The finding was explicitly proposed in the alternative to its flawed statutory interpretation, apparently following the CFTC's belated recognition that it can only support any exercise of its position limits authority under Section 4a(a) on a case-by-case basis and by making requisite findings of necessity. However, the "support" set forth in the Proposal's "necessity" discussion, including the narrow and dated instances of market disruptions that it cites, is fundamentally flawed and cannot provide an appropriate evidentiary basis of support for

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35 Instead, the CFTC cites the Original Position Limit Rules' proposing release for the proposition that "the Commission has historically associated [excessive speculation] with extraordinarily large speculative positions." 78 Fed. Reg. at 75685 n.60.

36 See 46 Fed. Reg. at 50940 n.5 (endorsing the concept "that exchanges are in the best position to determine the most efficacious level at which position limitations may be established").

37 As a threshold matter, we believe that using alternating theories of legal sufficiency to reach a decision on a rulemaking, especially one with as significant impacts on market participants and the economy as position limits, is an irresponsible use of the regulatory function that unnecessarily burdens public efforts to meaningfully comment on the legal basis for action. Cf. Am. Med. Ass'n v. Reno, 57 F.3d 1129, 1132 (D.C. Cir. 1995) ("Notice of a proposed rule must include sufficient detail on its . . . basis in law and evidence to allow for meaningful and informed comment . . . ."). An agency rulemaking is not analogous to a motion filed in a court, and an agency should not seek to impose broad requirements on market participants without having first determined that it is authorized to do so. The APA notice and comment rulemaking process is not the arena in which to throw competing legal theories against the wall and *see what sticks*.

CFTC-imposed position limits for a broad range of commodities. To the contrary, the limited, outdated and unpersuasive "evidence" discussed by the CFTC, as an alternative to its flawed reading of the statute, merely serves to underscore the fact that the CFTC has not satisfied the statutory requirements and has made no investigation whatsoever into the questions of whether "excessive speculation" exists, what kind of "burden" excessive speculation imposes, and whether limits are "appropriate" under the statutory standards set forth in the CEA for any of the commodities on which it purports to impose position limits. We believe that the CFTC's alternative "necessity finding" should be disregarded in its entirety.

1. The CFTC's Proffered Necessity Finding is Inadequate, Irrelevant, and Misapplied

In the Proposal, the CFTC attempted to ground its necessity finding in a "review" of two dated and irrelevant instances of market disruptions.[38] Specifically, the Commission used two case studies of markets in prior decades, and focused on futures contracts in the spot month for a single commodity, as the foundation for an across-the-board rule permanently imposing position limits on the 28 core referenced futures contracts and on any economically related futures contract, option, or swap. One of the two disruptions that the CFTC cites occurred in the late 1970s, in the silver futures market (the "Hunt Silver" incident).[39] The other disruption occurred in the mid-2000s, in the natural gas futures market (the "Amaranth Natural Gas" incident). The CFTC's case studies of these two instances of market disruption do not provide a basis for conclusions that are useful or relevant to addressing the current market and current market participants—certainly not with regard to the commodities at issue in the position limits proposed by this rulemaking.

<u>*The 1979–1980 Hunt Silver incident does not provide a basis for the Proposal.*</u>

The Proposal's first case study, an analysis of the Hunt Silver incident from 1979–1980, is in no way relevant to the Commission's required analysis or responsive to the statutory criteria under the CEA. The market has evolved in many ways over the past 34 years, including in terms of liquidity, size, types of market participants, types of contracts, and manner of trading. The only possible value that may be obtained by examining a 34-year-old case of market disruption is by

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38 <u>See</u> 78 Fed. Reg. at 75695–96. To make its necessity finding, the CFTC relies on "two studies"—one from over 30 years ago and the other by a Senate subcommittee—of the 132 studies and reports by a wide range of economists, regulators, and other market experts that it has reviewed. <u>Cf.</u> <u>Bus. Roundtable</u> v. <u>SEC</u>, 647 F.3d 1144, 1151 (D.C. Cir. 2011) ("The [SEC] completely discounted those studies [that reached the opposite result from the SEC] 'because of questions raised by subsequent studies, limitations acknowledged by the studies' authors, or [its] own concerns about the studies' methodology or scope.' The [SEC] instead relied exclusively and heavily upon two relatively unpersuasive studies . . . ." (citation omitted)). Further, these reports are not congressional "findings," (they were not approved by either a House of Congress or the President), or legislative history to the CEA.

39 <u>See</u> 78 Fed. Reg. at 75685 ("A rapid rise and subsequent sharp decline in silver prices occurred from the second half of 1979 to the first half of 1980 when the Hunt brothers and colluding syndicates attempted to corner the silver market by hoarding silver and executing a short squeeze.").

developing an understanding of how today's market would respond in a similar situation (which the CFTC does not attempt to analyze[40]). Only after conducting this type of analysis, and identifying the assumptions made, could any useful extrapolation be generated from which to develop new rules or guidelines for market participants on a prospective basis.

In addition, the fact that the Proposal's analysis is limited to the examination of a *single* incident related to a *single* market participant—a market participant with a position concentrated in the spot month—further underscores the absurdity of extrapolating any finding or conclusion to a broader market, including the imposition of non-spot month limits. Commodity markets are far from homogenous, as demonstrated by both our and the Commission's discussion of correlation requirements for netting and hedging certain positions (see below). And derivatives on commodities can serve completely different functions, and behave in different ways, depending on their tenor (for example, a spot month contract vs. non-spot month contracts). Section 4a(a) does not authorize the CFTC to adopt position limits today, across 28 commodities in all derivatives markets, solely because of activity in the spot month, in a contract for a single commodity, more than 30 years ago. Rather, as discussed above, the statute requires the Commission to impose position limits only on physical, non-excluded commodities and only if the Commission finds that such limits are "necessary" and "appropriate." Both the necessity and appropriate determinations must target the individual commodities to be covered by limits. As will be clearly demonstrated below, the CFTC has yet to consider even proposing a definition of "excessive speculation."

The 2006 Amaranth Natural Gas incident does not provide a basis for the Proposal.

Similar to its review of the Hunt Silver incident, the Proposal's review of the Amaranth Natural Gas incident, the natural gas trading of a single market participant during 2006, is both too dated and too limited to be applied in a practical manner—and the review is particularly ill-suited as a basis from which to demonstrate the necessity of position limits across a range of markets, market participants, and commodity classes. The review is too dated because even since 2006, the CFTC has incorporated many more tools *other than position limits*, that will allow it to address an outsized position, including enhanced market surveillance, broadened reporting requirements, broadened special call authorities, and exchange limits.[41] Most important among these is the increased visibility the Commission now obtains into the swap market via swap data repositories ("SDRs"), which once fully implemented will allow the Commission to observe the combined swaps and futures positions of a market participants in near real-time. The 2006 review is also too limited because the CFTC discusses the Amaranth positions related to a single commodity, natural gas, and Amaranth's primary intent was to "bang the close" by maintaining a concentrated position in a contract at the contract's expiry.[42]

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40 See infra Annex B, at 2 ("[The Commission's] Necessity Finding includes assertions of necessity not supported by the evidence of the cases it presents.").

41 These same tools similarly address the concerns presented by the Hunt Silver incident.

42 As described by Craig Pirrong in a paper prepared at ISDA's request, the Commission's analysis of the Amaranth positions—which it borrowed "basically . . . verbatim" from U.S. Senate

Yet, as noted above, the Proposal covers twenty-seven additional commodities, and would address positions in both the spot month and in all other months. These twenty-seven additional commodities are fundamentally different from natural gas in ways that even the Commission recognizes.[43] As suggested by the CFTC's discussion of the uniqueness of natural gas in the U.S. economy,[44] there is little reason to believe that the CFTC's recounting of two case studies provides relevant insight into the markets for all of the other commodities covered by the Proposal. Moreover, with respect to natural gas, the problematic issues associated with the Amaranth Natural Gas incident have been addressed and resolved by heightened monitoring efforts at the exchange level and related law and CFTC rulemakings.[45]

2. In Order to Determine that Position Limits are Necessary and Appropriate, the CFTC Must Define Excessive Speculation

As we demonstrated above, and as the District Court decision stated in vacating the Original Position Limit Rules: "The precise question, therefore, is whether the language of [CEA section 4a(a)(1)] clearly and unambiguously requires the Commission to make a finding of necessity prior to imposing position limits. The answer is yes."[46] In making that required finding, the Commission must find that excessive speculation exists, that it imposes "an undue and necessary burden on interstate commerce in [a specific] commodity," and that limits are "necessary" to

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Permanent Subcomm. on Investigations, Excessive Speculation in the Natural Gas Market: Staff Report with Additional Minority Views (2007)—was conclusory, and the CFTC's discussion fails to meet basic levels of rigor required of any peer-reviewed economic analysis. See infra Annex B, at 2. Moreover, the CFTC ignores the main issue in Amaranth, which was a "bang the close" case. Id. That is, the CFTC's discussion fails altogether to mention Amaranth's manipulative trading on expiration dates.

43 As discussed in greater detail below, the Commission's Proposal would hardly recognize a sufficient level of correlation as between different grades of crude oil for bona fide hedging purposes (see the discussion of the CFTC's proposed correlation requirements for cross-commodity hedging, below). Therefore, for the Commission to find that a limited and inconclusive study of an isolated disruption in the spot-month for natural gas contracts can be extrapolated across 27 derivatives markets for 27 different commodities, for the purpose of setting limits, is beyond the boundaries of rationality.

44 See 78 Fed. Reg. at 75691–92.

45 For example, Dodd-Frank has already made Amaranth's specific type of behavior illegal by amending the CEA to prohibit "any trading, practice, or conduct on or subject to the rules of a registered entity that . . . (B) demonstrates intentional or reckless disregard for the orderly execution of transactions during the closing period." Antidisruptive Practices Authority Contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act, 75 Fed. Reg. 67301, 67302 (Nov. 2, 2010) (quoting Dodd-Frank Act § 747); see also Antidisruptive Practices Authority, 76 Fed. Reg. 14943, 14946–47 (Mar. 18, 2011) (providing guidance on Dodd-Frank Act § 747).

46 ISDA v. CFTC, 887 F. Supp. 2d 259, 269 (D.D.C. 2012), 887 F. Supp. 2d at 269. In addition, see our discussion, above.

"diminish[], eliminate[e], or prevent[] such burden." The Commission's new Proposal does not satisfy these requirements, nor can it, absent a working definition of excessive speculation. Indeed, the Commission simply cannot impose an effective and "appropriate" prophylaxis without first defining the problem that position limits are necessary to solve. The CFTC has not, and simply cannot, demonstrate that limits are necessary and appropriate to reduce the negative effects of excessive speculation.

To further illustrate this foundational deficiency in its proffered "necessity finding," which is that the CFTC has not even considered whether to propose a definition of excessive speculation, consider the exchange during the October 2011 public meeting wherein the CFTC adopted the Original Position Limit Rules, confirming that the Commission does not have a definition of "excessive speculation":

> *Commissioner O'Malia*: "What is the Commission's working definition of 'excessive speculation?' And what criteria do we rely on to determine what speculation becomes excessive?"
>
> *Mr. S. Sherrod (CFTC Division of Market Oversight)*: "So we don't particularly have a working definition, but Congress directed us to implement these. And I'll turn to General Counsel [D.] Berkovitz."
>
> *Mr. D. Berkovitz (General Counsel of the CFTC)*: "Steve [Sherrod] is correct. The Commission does not have a definition of excessive speculation, . . . that's correct."
>
> *Commissioner O'Malia*: "How does the Commission determine that price movements are caused by excessive speculation?"
>
> *Mr. Sherrod*: "[T]he limits are designed to address traders with extraordinarily large positions. So they're targeted to the position size, not the impact that any particular trader has at a moment. These are based upon a formula, either based on the amount of available supply or the open interest in the market, designed to prevent a speculative trader from being extraordinarily large."
>
> *Commissioner O'Malia*: "Okay. So the Commission did not attempt to conclude that the limits are appropriate if it cannot identify a situation in which excessive speculation caused an unwarranted price movement. Correct?"
>
> *Mr. Berkovitz*: "[T]he Commission in the rules determined the appropriate levels to prevent the undue burdens on interstate commerce that Congress has found results from excessive speculation, so the Commission's judgment regarding the appropriate levels for the limits that would prevent these undue burdens."

> *Commissioner O'Malia*: "But we did—in doing that, we did not link-up what excessive speculation was and the price movement they had in order to set these limits. We have just made a determination."
>
> *Mr. Berkovitz*: "Pursuant to the Congressional direction, yes."[47]

Accordingly, the Commission cannot claim, under any metric of reasonableness, that its review of the two specific historic events discussed above meets the statute's necessity finding requirement. Moreover, even with respect to those two isolated historical events, the CFTC has failed to satisfy the statutory directive, because it has not shown that the "excessive speculation," to the extent it existed at all, would have been addressed by position limits, or that the regime the CFTC has proposed is "appropriate" to address any similar situations. The CFTC's reliance on these two historical incidents, as its necessity finding serves only to underscore the absence of any analysis or basis from which the Commission can purport to have met the statutory requirements for imposing the specific position limits proposed in this rulemaking. These isolated instances can in no way support the CFTC's sweeping adoption of a three-tiered position limit system applicable to 28 separate commodities.

3. The CFTC's Evaluation of Position Limit Data and Studies is Incomplete and Not Impartial and Cannot Support its Proffered Necessity "Finding"

To properly support the imposition of position limits, the CFTC must conduct an analysis using market data and trading activity on a current-and-prospective basis as applicable to the specific commodities at issue, and then only after defining and identifying excessive speculation. That is, the CFTC must review current data[48] in the context of today's market and market participants. As Commissioner O'Malia stated in his dissent, "[T]he [P]roposal . . . [f]ails to utilize current, forward-looking data and other empirical evidence as a justification for position limits."[49]

The CFTC's treatment of the relevant literature review is superficial and mistaken.

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47 Open Meeting on Two Final Rule Proposals Under the Dodd-Frank Act, CFTC 189–91 (Oct. 18, 2011) (transcribed colloquy between Scott D. O'Malia, Comm'r, CFTC; Stephen Sherrod, Division of Market Oversight, CFTC; and Dan Berkovitz, General Counsel, CFTC).

48 Specifically, the CFTC should utilize the daily reports it receives with respect to both futures and swaps markets. And the CFTC should provide market participants with an opportunity to examine any data the Commission relies on in order to independently evaluate the conclusions the Commission reaches.

49 78 Fed. Reg. at 75841 (O'Malia, Comm'r, dissenting).

Further, the CFTC fails to present economic evidence in support of the Proposal, nor could it because of the virtually unanimous academic agreement that commodity price changes have been driven by market conditions, rather than speculation.[50]

The CFTC attempts to evade this reality by asserting that "[s]ome studies may be read to support the imposition of Federal speculative position limits" and that there is a "lack of consensus" in the literature.[51] But these statements are mistaken, as the studies that the CFTC considers supportive of limits have been consistently and thoroughly refuted by subsequent scholarly work.[52] It is telling that the CFTC dismisses this work on the ground that it "do[es] not address or provide analysis of how the Commission should specifically implement position limits under section 4a of the CEA."[53] The fact that this literature does not address the CEA, or the Commission's erroneous construction of the CEA, does not make its refutation of the studies cherry-picked by the Commission any less telling.

Altogether, the Commission cites fourteen studies as confirmation of the need for position limits. Two of these studies are addressed above.[54] Of the remainder, seven address purported speculation in the oil and natural gas markets and thus provide no basis on which to impose limits on the twenty-seven additional commodities covered by the Proposal.[55] Likewise, the

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50 Although the CFTC does not present an economic case for position limits or claim that a review of the economic evidence would support the Proposal, the CFTC does list 132 studies and reports "relating to position limits" that it claims to have "reviewed and evaluated." See id. at 75784–87. Of these 132 documents, only 31 are cited at any point in the Proposal. Of these 31 documents, 25 are cited only in the part of the Proposal titled "Studies and Reports."

51 Id. at 75694.

52 For example, the CFTC favorably cites a 2009 study from Rice University that has been heavily and exceptionally criticized. See id. at 75695 n.142 (citing Kenneth B. Medlock III & Amy Myers Jaffe, James A. Baker III Inst. for Pub. Policy, Rice Univ., Who Is in the Oil Futures Market and How Has It Changed? (2009)). For an exposition of the deficiencies of this paper, see the assessment in Craig Pirrong, Have You Heard the One About the Baker Institute and the Oil Speculators?, Streetwise Professor (Aug. 28, 2009, 8:50 PM), http://streetwiseprofessor.com/?p=2454: "[T]his report is bilge. It relies on no rigorous economic analysis to support its contentions. Moreover, it is unscientific, eschewing any serious statistical analysis."

53 78 Fed. Reg. at 75694.

54 See supra Part I.B.1.

55 See Medlock & Myers Jaffe, supra note 52; Michael Greenberger, The Relationship of Unregulated Excessive Speculation to Oil Market Price Volatility, in Report of the Expert Group as Convened by the 2008 Ad-Hoc Energy Ministers Meetings Held in Jeddah and London (Int'l Energy Forum, Jan. 16, 2010); James D. Hamilton, Causes and Consequences of the Oil Shock of 2007–08, Brookings Papers on Econ. Activity, Spring 2009, at 215; Luciana Juvenal & Ivan Petrella, Speculation in the Oil Market, in Econ. Synopses (Fed. Reserve Bank of St. Louis, No. 8, 2012); Mohsin S. Khan, The 2008 Oil Price "Bubble," (Peterson Inst. for Int'l Econ., Policy Brief No. PB 09-19, 2009); Matteo Manera et al., Futures Price Volatility in Commodities Markets: The Role of Short Term vs Long Term Speculation (Fondazione Eni Enrico Mattei,

Senate subcommittee staff reports on speculation in the natural gas and wheat markets do not provide an adequate foundation upon which to base limits for twenty-eight different commodities, because they are limited to single commodities and reflect analyses performed over four years ago.[56]

The remaining studies are equally unavailing. For example, one paper addresses the "financialization" of commodity markets and concludes that futures prices of different commodities in the U.S. have become increasingly correlated with one another due to commodity index investment.[57] But the paper says nothing about position limits, takes no position on the extent of excessive speculation in U.S. commodities markets—and even expressly attributes some of the observed price volatility to fundamental market conditions, and affirmatively acknowledges that commodity index investment can be beneficial in leading to a more efficient sharing of commodity price risk.[58] Similarly, the UN studies cited by the Commission expressly concede that they lack evidence tying speculation to changes in commodity prices.[59]

Despite the obvious infirmities in the studies it cites, the Commission claims that *some* studies "conclude there is significant evidence of the impact of speculation" in *futures markets* and that *some* studies "have determined that . . . [speculative] activity may increase price pressures, thereby exacerbating [a] price movement."[60] In fact, almost all of the listed studies that address whether excessive speculation distorts prices find no adverse effects.

Nota di Lavoro No. 45.2013, 2013); Kenneth J. Singleton, Investor Flows and the 2008 Boom/Bust in Oil Prices (March 23, 2011) (unpublished manuscript), available at http://ssrn.com/abstract=1793449. The attached Verleger report, infra Annex A, provides a powerful demonstration of the adverse effects that position limits would have in the energy markets.

56 See U.S. Senate Permanent Subcomm. on Investigations, supra note 42; U.S. Senate Permanent Subcomm. on Investigations, Excessive Speculation in the Wheat Market: Majority and Minority Staff Report (2009).

57 Ke Tang & Wei Xiong, Index Investment and Financialization of Commodities, 68 Fin. Analysts J. 54 (2010).

58 Id. at 3.

59 UN Conference on Trade and Development, The Global Economic Crisis: Systemic Failures and Multilateral Remedies 38 (2009) ("[T]he non-transparency of existing data and lack of a comprehensive breakdown of data by trader categories make it difficult to examine the link between speculation and commodity price developments directly. The strongest evidence is found in the high correlation between commodity prices and the prices on other markets that are clearly dominated by speculative activity."); UN Trade and Development Report, Financialization of Commodity Markets 78 (2009) (noting that "it is difficult to conduct a detailed empirical analysis of the link between speculation and commodity price developments" due to lack of empirical evidence).

60 Position Limits for Derivatives, 78 Fed. Reg. 75680, 75694 (Dec. 12, 2013) (emphasis added).

With regard to "the concept of position limits," the CFTC divided studies into those that were (in the CFTC's view) supportive of position limits and those that did not "view[] position limits in a positive light."[61] The Commission's division of the studies, however, does not fairly reflect the lack of support for position limits in the literature, the vast bulk of which indicates that position limits are both unnecessary and ineffective. The CFTC reads the "supportive group" of studies to express that "speculative position limits are an important regulatory tool and that the CFTC should implement limits to control excessive speculation."[62] Again, however, the CFTC fails to mention that the *vast majority* of the studies in the record directly refute the necessity and appropriateness of position limits. Indeed, "current regulatory proposals to limit speculation—especially on the part of index funds—are not justified and likely will do more harm than good."[63]

Further, the CFTC relies, for its conclusion on the likely effectiveness of position limits, on the factual premise that if "speculative money that flowed into [derivatives] markets will be forced to flow out, . . . the price of commodities futures will come down substantially."[64] The self-published study[65] from which the CFTC takes this premise has been thoroughly rebutted by respected scholars in academic, economics-focused journals as unreliable, methodologically flawed, and based upon unrepresentative anecdotes.[66] The CFTC does not acknowledge these flaws, let alone attempt to address them. Moreover, the poorly supported premise is contrary to the findings in "most of the previous literature—there seems to be little evidence that index-fund

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61 See id. at 75694–95.

62 Id. at 75694.

63 Dwight R. Sanders & Scott H. Irwin, The Impact of Index Funds in Commodity Futures Markets: A Systems Approach, 14 J. Alternative Invs. 40, 48 (2011).

64 Id. at 75695 ("[S]peculative position limits worked well for over 50 years and carry no consequences. . . . Until speculative position limits are restored, investor money will continue to flow unimpeded into the commodities futures markets and the upward pressure on prices will remain." (quoting Michael Masters & Adam White, The Accidental Hunt Brothers: How Institutional Investors Are Driving Up Food and Energy Prices (2008)) (internal quotation marks omitted).

65 See id. at 75786, item 86.

66 See Sanders & Irwin, supra note 63, at 43, 47 ("Arguments that index funds impact commodity prices [e.g., those of Masters and White [2008]] focus primarily on the role of long-only index funds that purchase commodity futures as an asset class. . . . [T]here is no evidence of a linkage between index trader positions in commodity futures markets and price levels."); Dwight R. Sanders & Scott H. Irwin, A Speculative Bubble in Commodity Futures Prices? Cross-Sectional Evidence, 41 Agric. Econ. 25, 26 (2010) ("Masters' evidence is limited to anecdotes and the graphical (temporal) correlation between money flows and prices (Masters and White, 2008)."); Scott H. Irwin et al., Devil or Angel? The Role of Speculation in the Recent Commodity Price Boom (and Bust), 41 J. Agric. & Applied Econ. 377, 379–80 (2009) ("This discussion should make it clear that it is wrong to draw a parallel (e.g., Masters and White, 2008) between index fund positions and past efforts to 'corner' commodity markets, such as the Hunt brother's effort to manipulate the silver market in 1979–1980.").

investing is exerting a measurable effect on commodity futures prices."[67] Similarly, the CFTC relies on a UN rapporteur's report[68] that has not withstood scrutiny.[69] Uncritical reliance on these discredited findings in marginal studies that go against the weight of the available economic evidence *cannot* be the foundation for a necessity finding.

The unrefuted findings cited by the CFTC uniformly demonstrate that speculation has not caused commodity price changes and that position limits are ineffective at reducing volatility.

Aside from two outdated, discredited reports, the CFTC does not put forward any academic support for the need for, or efficacy of, position limits and wholly disregards studies in the record that are adverse to position limits. Instead, the CFTC claims that "[s]tudies that militate against imposing any speculative position limits appear to conflict" with two conclusions that the CFTC has reached about Section 4a(a): first, "with the Congressional mandate . . . that the Commission impose limits on futures contracts, options, and certain swaps for agricultural and exempt commodities," and second, "with Congress' determination, codified in CEA section 4a(a)(1), that position limits are an effective tool to address excessive speculation as a cause of sudden or unreasonable fluctuations or unwarranted changes in the price of such commodities."[70]

But the Commission cannot answer an economic question—are the limits at issue necessary, effective, and appropriate?—with a legal proposition, especially not one in the section of the Proposal that purports to base new position limits on empirical evidence rather than a supposed congressional mandate. And in fact, the studies and evidence that the Commission seeks to ignore are overwhelming. A 2009 study analyzed data collected by the Commission and found "that speculative activity does not affect prices" and "actually reduces volatility."[71] A study conducted by an economist at the Divisions of Research & Statistics and Monetary Affairs of the Federal Reserve Board found "no evidence that speculative activity in futures markets for industrial metals caused higher spot prices in recent years."[72] The International Organization of

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[67] James D. Hamilton & Jing Cynthia Wu, Effects of Index-Fund Investing on Commodity Futures Prices 29 (Univ. of Cal. Ctr. for Energy & Envtl. Econ., Working Paper No. WP-070, 2013), available at http://www.uce3.berkeley.edu/WP_070.pdf; see also infra Annex A, at 10 ("Prices quoted in cash-settled markets cannot influence these markets unless the party with a large position in the cash-settled market also has a position in the physical market.").

[68] 78 Fed. Reg. at 75695 (quoting Olivier de Schutter, Briefing Note 02, Food Commodities Speculation and Food Price Crises: Regulation to Reduce the Risks of Price Volatility 8 (2010)).

[69] See, e.g., Brian D. Wright, The Economics of Grain Price Volatility, 33 Applied Econ. Persp. & Pol'y 32, 51–52 (2011) (criticizing the analysis of price jumps by de Schutter, supra note 68, that forms the basis for the rapporteur's recommendations).

[70] 78 Fed. Reg. at 75695.

[71] Celso Brunetti & Bahattin Büyükşahin, Is Speculation Destabilizing? 4 (Apr. 22, 2009) (unpublished manuscript).

[72] George M. Korniotis, Does Speculation Affect Spot Price Levels? The Case of Metals with and Without Futures Markets abstract (Fed. Reserve Bd. Divs. of Research & Statistics & Monetary Affairs, Fin. & Econ. Discussion Series No. 2009-29, 2009).

Securities Commissions ("**IOSCO**")—an organization to which the Commission belongs—concluded that "[r]eports by international organizations, central banks and regulators . . . suggest that economic fundamentals, rather than speculative activity, are a plausible explanation for recent price changes in commodities."[73]

Numerous studies also showed that position limits were ineffective at reducing price volatility and may actually increase it. For example, one study assessed speculative activity before and after a 2005 decision by the Chicago Board of Trade to relax position limits.[74] The study found "no large change in measures of volatility after the change in speculative limits" and concluded that "there is little suggest that the change in speculative limits has had a meaningful overall impact on price volatility to date."[75] A 2011 study found that rather than "curtailing price swings," position limits "could exacerbate them" by "inhibit[ing] the freedom of hedgers, thereby reducing [liquidity]."[76]

The published findings that the CFTC *quotes*, but does not bother to refute, include:

- "that position limits will not restrain manipulation;"[77]
- "that position limits in the agricultural commodities have not significantly affected volatility;"[78]
- that position limits "will not prevent asset bubbles from forming or stop them from bursting;"[79]
- that position limits "should be set at an *optimal* level so as to not harm the affected markets;"[80]

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73 Technical Comm., IOSCO, Task Force on Commodity Futures Markets: Final Report 3 (2009).

74 See Scott H. Irwin et al., The Performance of Chicago Board of Trade Corn, Soybean, and Wheat Futures Contracts After Recent Changes in Speculative Limits 1 (Am. Agric. Econ. Ass'n, Selected Paper, 2007).

75 Id. at 16.

76 M. Shahid Ebrahim, Can Position Limits Restrain "Rogue" Trading? 9, 27 (Working Paper, 2011), quoted in part in Position Limits for Futures and Swaps, 76 Fed. Reg. 71626, 71664 n.378 (Nov. 18, 2011), vacated, ISDA v. CFTC, 887 F. Supp. 2d 259 (D.D.C. 2012).

77 Position Limits for Derivatives, 78 Fed. Reg. 75680, 75695 (Dec. 12, 2013) (citing Muhammed Ebrahim & Rhys ap Gwilym, Can Position Limits Restrain Rogue Traders?, 37 J. Banking & Fin. 824 (2013)).

78 Id. (citing Scott H. Irwin et al., supra note 74).

79 Id. (citing John E. Parsons, Black Gold & Fool's Gold: Speculation in the Oil Futures Market (Ctr. for Energy & Envtl. Policy Research, No. 09-013, Sept. 2009)); see also Letter from John M. Damgard, President, Futures Indus. Ass'n, to David Stawick, Sec'y, CFTC 7 n.14 (Mar. 25, 2011) ("[A]ll of the empirical evidence, including evidence developed by the Commission's Staff, shows that speculative investments in commodities and related listed and OTC derivatives have . . . , if anything, had a moderating influence on commodity prices." (citing additional empirical evidence)).

- "that position limits should be administered by DCMs, as those entities are closest to and most familiar with the intricacies of markets and thus can implement the most efficient position limits policy;"[81] and
- "that increasing ex-post penalties would be more effective at deterring manipulative behavior."[82]

It is hard to imagine a more effective demonstration of the Commission's lack of analytic support for the Proposal than the CFTC's failure to provide a reasoned response to *any* of the above findings in the studies it purports to have reviewed.

In addition to the studies that are already in the record, we would also direct the Commission to two additional papers, attached to this letter, which have been prepared by experts retained by ISDA for the purpose of addressing position limits and the impact of the Commission's Proposal—one from Philip Verleger, as Annex A, and one from Craig Pirrong, as Annex B. We urge the Commission to fully review and consider the concerns highlighted in these papers and to address those concerns prior to moving forward with the Proposal.

C. The CFTC Has Again Failed to Consider the Costs and Benefits of its Proposal

Moving past its flawed statutory interpretation, and its wholly inadequate necessity finding, we also stress that the CFTC has once again failed to adequately consider the costs and benefits of the proposed position limits rules—notwithstanding that our Previous Comments identified similar concerns with respect to the Commission's proposal that preceded the Original Position Limit Rules. Significantly, the District Court vacated the original rules before reaching the cost-benefit challenges presented in that lawsuit. An appropriate assessment of the costs and benefits of the Proposal involves realistic analysis of the impact position limits will have on commodities markets, market participants, and the economy generally.[83] The Proposal does not provide such an analysis.

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80 Id. (emphasis added) (citing Randall Wray, The Commodities Market Bubble: Money Manager Capitalism and the Financialization of Commodities (Levy Econ. Inst. of Bard College, Pub. Policy Brief No. 96, 2008)).

81 Id. (citing CME Grp., Excessive Speculation and Position Limits in Energy Derivative Markets (2009)).

82 Id. (citing Craig Pirrong, Squeezes, Corpses, and the Anti-Manipulation Provisions of the Commodity Exchange Act, 1994 Reg. 52).

83 As recently reinforced by the D.C. Circuit Court of Appeals, the CFTC's cost-benefit discussion should identify marginal benefits of the rule in the existing regulatory regime, identify benefits of the rule that do not depend on later rulemaking, evaluate the costs and benefits appropriately (given limitations on available data), see Inv. Co. Inst. v. CFTC, 720 F.3d 370, 378–79 (D.C. Cir. 2013), consider adequately incremental efficiency costs to market participants, and adequately address the probability that the rule will be of no net benefit because of the expected circumstances of its application, see Bus. Roundtable v. SEC, 647 F.3d 1144, 1155–56 (D.C. Cir. 2011). The discussion should not inconsistently and opportunistically frame the rule's costs and

1. Required Statutory Cost-Benefit Considerations

In general, CEA Section 15(a) requires the CFTC to evaluate proposed rules "in light of" the following considerations: (i) protection of market participants and the public; (ii) the impact of position limits on the efficiency, competitiveness, and financial integrity of derivatives markets; (iii) the impact on markets' ability to provide price discovery; (iv) sound risk management practices; and (v) other public interest considerations.[84] As discussed by the District Court, the CFTC must also find a "reasonable likelihood that excessive speculation will pose a problem in a particular market, and that position limits are likely to curtail it without imposing undue costs."[85]

Further, contrary to the CFTC's claim,[86] the Investment Company Institute court permitted the CFTC to escape its legal duty to "conduct a quantitative economic analysis" only when a purported benefit is "unquantifiable,"[87] and the CFTC always must "exercise its expertise to make tough choices about which of . . . competing estimates is most plausible, and to hazard a guess as to which is correct, even if . . . the estimate will be imprecise."[88] Similarly, the CFTC must consider the costs and benefits of its Proposal not only on in the context of domestic markets but also based on whether the rules would apply on an extraterritorial basis, and it must assess the costs and benefits of applying the rules on an extraterritorial basis.

2. The CFTC Failed to Conduct the Statutorily Required Cost-Benefit Analysis

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benefits, fail adequately to quantify known costs, neglect to support its predictive judgments, contradict itself, or fail to respond to substantial problems raised by commenters. See id. at 1148–50. Moreover, the attached papers from Craig Pirrong and Philip Verleger both underscore, from an economic perspective, what is expected in a proper evaluation of the costs and benefits of position limits for derivatives. See infra Annexes A & B.

84 7 U.S.C. § 19(a). In this evaluation, the CFTC must "examine[] the relevant data and articulate[] a satisfactory explanation for its action including a rational connection between the facts found and the choice made." Inv. Co. Inst., 720 F.3d at 376 (internal quotation marks omitted).

85 See ISDA, 887 F. Supp. 2d at 273. The CFTC claims, "Congress could not have contemplated that, as a prerequisite to imposing limits, the Commission would first make [this] sort of necessity determination . . . ." 78 Fed. Reg. at 75682–83. But an agency may not rely upon "difficult[ies]" in "determin[ing] the costs" to avoid its obligation "to determine as best it can the economic implications of the rule it has proposed." See Chamber of Commerce v. SEC, 412 F.3d 133, 143 (D.C. Cir. 2005).

86 See 78 Fed. Reg. at 75760 n.719 ("[T]he D.C. Circuit held that CEA section 15(a) imposes *no duty* on the Commission to conduct a quantitative economic analysis . . . .") (emphasis added) (citing Inv. Co. Inst., 720 F.3d at 379).

87 Inv. Co. Inst., 720 F.3d at 379 ("[T]he law does not require agencies to measure the immeasurable. CFTC's discussion of *unquantifiable* benefits fulfills its statutory obligation . . . ." (emphasis added)).

88 See Pub. Citizen v. Fed. Motor Carrier Safety Admin., 374 F.3d 1209, 1221 (D.C. Cir. 2004).

In terms of identifying benefits, the CFTC asserts that position limits are a prophylactic measure and thus that it is not required to determine the existence or magnitude of any benefit. That is fundamentally mistaken. The Commission may not impose a prophylaxis that will impose costs without first determining the presence and seriousness of the purported threat to be addressed, even if prophylactically. An active and present danger across numerous commodities markets could justify one level of costs, whereas a fleeting and illusory "risk" (such as one that, at most, emerged twice over a 35-year period in just two markets under markedly different regulatory regimes) would justify few, if any, regulatory costs. Given the lack of evidence of excessive speculation that would warrant imposing position limits, the CFTC cannot fail to conduct an economic analysis of the likely impact of the proposed rules on markets and market participants.

In contrast, the CFTC does not quantify (or adequately quantify) the harm that market experts predict that position limits will impose, in the context of—

- Liquidity for bona fide hedgers, increased volatility, and thus increased hedging costs;[89]

- Disruption to the price discovery function served by the derivatives markets;

- Causing price discovery in commodities to shift offshore;

- Implementation costs and the initial building of compliance and monitoring systems;[90] and

- On-going reporting and on-going monitoring costs for market participants.

Specifically, the CFTC declines to quantify several costs that we believe will be significant if the Proposal were adopted, including the costs of—

- A limited definition of bona fide hedging, and the direct impact that the narrowed definition will have on commercial firms that use derivatives markets to manage price risks, secure financing, and grow their businesses;[91]

- "Altering speculative trading strategies" to meet the Commission's restrictive proposed list of enumerated "bona fide hedges," which would also include the costs of altering trading strategies that are true hedges but do not meet the Commission's definition;[92]

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89 As demonstrated in Verleger's paper, the impact of position limits in the energy industry alone could cause volatility and price increases, due to decreased commercial activity of energy producers, thus causing increased prices, of approximately $100 billion per year to U.S. consumers and $500 billion per year to global consumers. See infra Annex A, at 3.

90 We understand that the real estimated cost to develop the information technology systems necessary to track and report positions across multiple deal capture systems will be approximately $750,000 to $1,000,000 per firm. The Commission's estimates fail to account for this cost.

91 See the attached paper by Philip Verleger, infra Annex A, detailing these costs.

- "[R]eassess[ing] and modify[ing] existing trading strategies in order to comply with spot- and non-spot-month position limits," particularly for "swaps-only entities" or contracts outside of the spot month;[93]

- "[A]mend[ing] [DCMs'] current aggregation and bona fide hedging policies to conform with proposed § 150.4 and proposed § 150.1, respectively[, which] may include burdens associated with reviewing and evaluating current standards to assess differences that must be addressed, employing legal counsel to aid in ensuring conformity, and transitioning from an old standard to the new one" and "incur[ring] costs to develop" such conforming policies for SEFs;[94] and

- Creating a "compliant application regime [for SEFs under § 150.5(a)(2)(C) and (b)(5)(C)], which will require an initial investment similar to that which DCMs have already made."[95]

More concerning, and more generally, the CFTC does not consider the costs of the legitimate concern it identifies "that liquidity and price discovery may be diminished, because certain market segments, i.e., speculative traders, are restricted."[96] The CFTC's argument for declining to do so seems rely on its view that, because the CFTC will "expand[] limits to additional markets incrementally," the burden of changing strategies will "happen incrementally over time."[97] However, a bad policy does not become a good policy just because the harm is imposed incrementally. Moreover, the CFTC's contention that this effect will be realized "incrementally" is solely conjecture on its part and not based on any study or analysis.

Ultimately, the theme of the CFTC's proposed cost-benefit review is a repeated refusal to even attempt to identify the relative size of costs and benefits resulting from the imposition of position limits. The CFTC instead reiterates the difficulty of quantifying costs and benefits and re-

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92 78 Fed. Reg. at 75763–64; see infra Part II.B. The CFTC incorrectly anticipates that the costs resulting from these alterations will be "small." As reinforced by Verleger's paper, infra Annex A, we strongly believe that the Commission wholly misperceives the detrimental impact that its Proposal will have by limiting the availability of hedging to commercial producers of any given commodity. By removing the ability to hedge, the Commission removes the ability of many market participants to participate not just in the derivatives markets, but in conducting their business altogether.

93 78 Fed. Reg. at 75767.

94 Id. at 75775–76.

95 Id. at 75776.

96 Id. at 75767.

97 Id. Tellingly, the CFTC does not mention its incremental approach in its discussion of the *benefits* of proposed Section 150.2(a)–(b). See id. at 75766–67; cf. Bus. Roundtable v. SEC, 647 F.3d 1144, 1149 (D.C. Cir. 2011) ("[T]he [SEC] inconsistently and opportunistically framed the costs and benefits of the rule . . . .").

affirms its commitment to "implementing" the purported mandate in section 4a(a) to impose position limits, without regard to cost or statutorily-required analysis.

3. The CFTC Does Not Give Adequate Consideration to Known Alternatives

In addition, where a "facially reasonable" alternative to an agency proposal is suggested, the agency must consider the alternative or give some reason for declining to do so, as long as the alternative is "'neither frivolous nor out of bounds.'"[98] As we discuss in more detail in Part II, below, the Proposal fails to incorporate a variety of proposals relating to specific provisions of the Proposal, including the proposals that we preview in the following two paragraphs.[99]

Generally, the Commission should consider removing the most flawed elements from the Proposal, including non-spot-month limits, arbitrarily set limit levels, and limits on financially settled contracts. The CFTC should also consider our, and other, proposals to better tailor position limits to market realities, such as recognition of cross-commodity netting, a responsible plan for cross-border application of position limits, and several reforms to the Proposal's new definition of "bona fide hedging."

Finally, as noted in the Overview, above, the CFTC has new data sources (namely, SDRs) and should take the time to analyze both (i) the nature of the swaps market into which it now has a view and (ii) the impact that position limits will have on these markets and market participants. SDR data, when fully developed, will give the Commission insight into individual market participants, volumes, and open interest levels for swaps (by swap, by commodity, and by market participant). Given the availability of SDR data to the CFTC, the failure to use such data (perhaps because, as the CFTC concedes, the data's reliability is still in development) only re-emphasizes the conclusion that the CFTC has not conducted the statutorily required consideration of costs and benefits in any meaningful way.

II. Comments on the Proposed Rules

If the Commission rejects the comments above and determines to go forward with the Proposal notwithstanding its duties and obligations under CEA sections 4a(a) and 15(a), we believe that substantial changes must be made to the proposed rules in order to comply with the statute and achieve the Commission's stated objectives without unnecessarily harming or disrupting commodity markets and market participants. In addition, we urge the CFTC first to consider the full scope of its regulatory toolbox in the context of monitoring large positions and addressing concerns related to excessive speculation. By utilizing existing tools, the Commission could achieve its regulatory objectives in a manner that would be substantially less harmful to the

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[98] See Am. Gas Ass'n v. Fed. Energy Regulatory Comm'n, 593 F.3d 14, 19–20 (D.C. Cir. 2010) (quoting Chamber of Commerce v. SEC, 412 F.3d 133, 145 (D.C. Cir. 2005)) (internal quotation marks omitted). This requirement is all the more clear when a proposal is raised by a dissenting commissioner of the rulemaking agency. See id.

[99] See also Annex B, below, which highlights, among other things, that the Commission has failed to consider whether alternatives to position limits could achieve (and in fact, are achieving) the same purposes that position limits seek to serve.

markets—and more consistent with the statute—than the proposed position limit regime. As we will discuss below, the rules set forth in the Proposal are an imprecisely tailored *one-size-fits-none* approach that will impose significant, immediate, and unjustified costs on markets and market participants.

A. Position Limits

1. Non-Spot-Month Limits

The Proposal would fix position limits in the spot month, any month other than the spot month, and in all months combined. ISDA urges the Commission to withdraw in its entirety any aspect of the Proposal that would impose position limits outside of the spot month (*i.e.*, non-spot month limits). There is no justification *whatsoever* for non-spot-month limits. Such limits are not supported by any data that has been presented by the Commission, and the Commissions relies entirely on conclusory statements to support the proposed non-spot month limits. As a result, the proposed position limits, to the extent they would apply in the non-spot month, are arbitrary and capricious and thus cannot be lawfully adopted as final.[100]

The CFTC's necessity analysis is inapplicable to non-spot month concerns.

As an initial point, the CFTC's necessity findings, which, as discussed above, are inadequate in several respects, offer no support for the imposition of non-spot-month position limits. The Hunt Silver incident was an attempt to corner the physical silver market by standing for delivery in the spot month (because delivery occurs in or after the spot month) on a long-futures contract position. It is not possible to corner the physical supply of a commodity by taking an "outsized" position beyond the spot month, where delivery cannot occur—rather, in order to stand for delivery and effect the corner, a trader would have to hold the position into the spot month and through delivery.[101] Even in the data presented by the Commission, the price distortion identified occurred in the spread between spot-month prices (which were distorted) and deferred-month prices (which were not impacted by the spot-month dislocation).[102] In reviewing the Hunt Silver incident, the Commission does not identify, and neither can we find, any support for either the necessity or usefulness of limits in the non-spot month.

With respect to the Commission review of the 2006 natural gas market, the Amaranth Natural Gas incident, the Commission concludes, without analysis or demonstration, that Amaranth's

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100 See Motor Vehicle Mfrs. Ass'n of the U.S. v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 41 (1983) (permitting an agency's action in promulgating rules under informal procedures to "be set aside if found to be 'arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law'" (quoting 5 U.S.C. § 706(2)(A)).

101 As Craig Pirrong notes, "[A] corner or squeeze episode provides no justification of the necessity of imposing position limits outside the spot month. Thus, the Hunt Silver episode cannot be invoked to prove the necessity of any and all month limits." Infra Annex B, at 2.

102 See 78 Fed. Reg. at 75687, 75688 fig. 2.

large positions "distorted the market."[103] However, that declaration is not tied to any meaningful empirical evidence or analysis, and the CFTC ignores the fact that Amaranth was actually another case of spot-month misconduct, where Amaranth attempted to "bang the close."[104] Still, the CFTC attempts to conclude from this limited review of a single episode in the spot month of a single commodity that it should impose limits on derivatives for the twenty-seven other commodities covered in the Proposal, in both the spot month and across any and all months. Both aspects of Commission's "necessity finding" clearly fail to establish a basis for imposing non-spot month limits, even on silver and natural gas, let alone for any other commodity.

Further underscoring the absence of any Commission effort to examine the need for, and establish the required basis for, the limits it is proposing (in this case, for both spot-month and non-spot month limits), the CFTC staff presentation at the public meeting claimed that the limits in the Proposal are set at such high initial levels that they should not have a great impact.[105] There was no support or rationale offered for this assertion and it was clear that no analysis had been undertaken. This method of setting limits, without any underlying study or effort to determine the appropriateness of the levels, is contrary to the statute and confirms that the CFTC is proposing limits for the sake of limits. This is simply not a justifiable basis from which to exercise the CFTC's position limits authority under any plausible interpretation of CEA Section 4a(a).

The proposed non-spot-month formula is arbitrary and relies on inadequate inputs.

The Proposal's methodology for setting non-spot-month limits is not only an arbitrary formula borrowed from decades-old precedent (and not reviewed for appropriateness in the context of today's markets or the twenty-eight different commodity markets to which the Commission seeks to apply it),[106] but is pegged to data that the Commission itself acknowledges as

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103 As noted by Craig Pirrong, the Commission's analysis of the Amaranth positions was conclusory and the CFTC's discussion fails to meet basic levels of rigor required of any peer reviewed economic analysis. See infra Annex B, at 2. Moreover, the CFTC ignores the main issue in Amaranth, which was a "bang the close" case. That is, the CFTC's discussion fails altogether to mention Amaranth's manipulative trading on expiration dates.

104 See Pirrong's comments on the Amaranth case, infra Annex B, at 2.

105 Comments from Stephen Sherrod, of the CFTC's Division of Market Oversight, noted that "staff, over the decades, has consistently recommended position limits that are at the outer bounds, high levels," that "staff again recommends using the traditional formulas that set limits at kind of the outer bounds on the high side," and that the proposed limits "are certainly erring on the high side." See Public Meeting, CFTC 72–73 (Nov. 5, 2013) (transcript), available at: http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission_110513-trans.pdf.

106 Pirrong articulates the criticism as follows: "The rule limits a speculator's position to between 10 percent and 2.5 percent of open interest, in the any and all months, depending on the size of the market. In the two examples, the traders in question held positions far in excess of these limits. Thus, even if one agrees with the conclusions the Commission draws from these episodes (which I do not), they cannot show that the limits that the Commission has chosen are necessary to

unreliable—imprecise calculations of open interest. Describing the SDR data that may serve as a primary input source for determining open interest, which is the fundamental variable of the proposed formula for non-spot month limits, the CFTC notes: "[s]everal reporting entities hav[e] submitted data that contained stark errors." [107] The Commission further noted that it is unable to anticipate which of its currently incomplete and inadequate data sets will ultimately prove the least flawed, with the Proposal only providing that the CFTC may look to either Part 20 large swaps trader reporting data or, alternatively, Part 45 SDR data, in order to determine open-interest levels. We agree with Commissioner O'Malia that the Commission must base its approach to position limits on current and reliable data[108]—and only then can it proceed to properly evaluate the Congressionally mandated questions of necessity and appropriateness that must accompany any decision to impose position limits under the CEA.

The CFTC should propose accountability levels instead of fixed position limits in the non-spot month.

In light of the absence of a complete data set, and to avoid unnecessary costs attributable to imprecise setting of limits, the Commission should not set fixed limits in the non-spot month. Rather, the Commission should use other methods for monitoring such positions—for example, accountability levels. The CFTC failed to explain why it did not select accountability levels, rather than fixed position limits, to manage and monitor traders with large positions outside of the spot month. The CEA does not prohibit accountability levels, and the CEA requires the Commission to set limits on physical, non-excluded commodities only as necessary and appropriate. Accountability levels will permit the Commission to achieve the same purpose as position limits, but without imposing undue costs on market participants that will accompany fixed limits.

2. The Commission's Multiple Existing Tools to Address Large Positions

We believe that the Commission should utilize its existing tools to address concerns regarding large positions, particularly in the absence of any demonstration that position limits are necessary or will be effective (as described above), and more generally in the absence of reliable data from which to base limit levels. The Commission's surveillance capabilities and special call authorities provide it with a broad view into both markets and individual traders. The Commission also has the ability to review specific positions on any given DCM or SEF on a

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achieve the purpose of the statute that authorizes the Commission to impose limits as necessary." Infra Annex B, at 3.

107 78 Fed. Reg. at 75734 & n.428.

108 In his dissenting statement, Commissioner O'Malia noted: "[T]he Commission should have taken the time to analyze the new data, especially from the swaps market, that has been collected under the Dodd-Frank Act. It is especially troubling that the large trader data being reported under Part 20 of Commission regulations is still unreliable and unsuitable for setting position limit levels, almost two full years after entities began reporting data, and that we are forced to resort to using data from 2011 and 2012 as a poor and inexact substitute." Id. at 75841 (O'Malia, Comm'r, dissenting).

daily basis, as well as to request cleared position data at the individual trader level from any clearinghouse that is registered with the Commission as a derivatives clearing organization. In addition, to the extent that the Commission has or develops concerns about an individual trader, particularly in the context of a large position, its large trader reporting rules for both swaps and futures expressly permit the Commission to request position information directly from such large traders along with information about any related activity in swaps, futures, options, and forwards.[109] Beyond these information gathering tools, the Commission has the authority to direct a DCM or SEF to manage, liquidate, or reduce a position under appropriate circumstances. More importantly, the Commission permits and requires exchanges to set their own position limits. And in the now six years since the financial crisis, with the combination of the CFTC's surveillance capabilities and the oversight provided by exchanges, we simply have not observed instances or even claims of excessive speculation. The Commission must balance the availability and effectiveness of these existing tools with the burdens that will accompany the rules set forth in the Proposal. If the Proposal's position limits fail to increase the ability of the Commission to address concerns in connection with large positions, and we believe that they do not do so, they represent only an increased compliance burden on market participants with no corresponding benefit to either the Commission or the public.

3. Financially Settled Contracts

The Commission has not demonstrated that financially or cash-settled contracts are either disruptive to the markets or relevant in any way for the purpose of the concerns the Commission attempts to address with position limits. Because a cash-settled contract does not, by definition, result in any activity in the underlying physical commodity (these contracts are, instead, dependent upon and generally price based on a reference to the physical market), the potential for a position in a cash-settled contract to disrupt or distort the price of a physical commodity is essentially non-existent.[110] Position limits on such contracts will have no impact other than to reduce liquidity. There is no evidence, nor does the Commission offer any evidence, that trading in cash-settled contracts influences the prices of either physically-settled contracts or of physical commodities, generally. Rather, these markets are used by both commercial and financial hedgers alike in the process of managing risks resulting from activity in the physical markets. The benefit or purpose of limits on positions in cash-settled contracts is unidentified, yet the costs due to reduced liquidity for hedgers that use the cash-settled contacts will be tangible and inevitable. Accordingly, we believe the Commission should withdraw any aspect of the Proposal that would impose position limits on financially or cash-settled contracts.

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109 See 17 CFR §§ 18.05, 20.6.

110 In a related discussion in his letter, Verleger describes: "As bystanders, buyers and sellers of cash contracts cannot affect the price of the commodity being traded in physical markets. Furthermore, logic suggests those trading in the physical market would meet any attempt to manipulate the cash contract by bidding against the trader. Their profitable arbitrage would force prices to converge. . . . To put it bluntly, there should be no limits on cash-settled contracts, given the inability of a participant to influence physical market prices by trading in the cash-settled market." Infra Annex A, at 10.

For similar reasons, if adopted, a conditional spot-month limit[111] should not be limited to traders that **only** hold cash-settled contracts. The Commission should explore a higher cash-settled limit that allows participation in the physically settled market similar to the Original Position Limit Rules.

4. Spot-Month Limits

The Proposal's framework for setting spot-month limits, which relies on a single and unspecified measure of "estimated deliverable supply," is critically deficient and therefore inappropriate. First, the CFTC has not established a relationship between "estimated deliverable supply" and spot-month potential for manipulation or excessive speculation. Moreover, if such a demonstration were to be made, it must be set forth on a unique basis for each commodity for which the Commission intends to impose limits. Yet the Commission's Proposal would impose one level, an arbitrary twenty-five percent,[112] across derivatives products on twenty-eight different commodities, each with varying factors that would inform whether contracts representing any percentage of deliverable supply afford an individual trader with the ability to distort or manipulate prices.

Instead of using a single standard in setting spot-month limits, the CFTC should take into account various characteristics of each referenced contract, including delivery points, the nature of the market for the underlying cash commodity, and the nature of the relationship between a given commodity and related and substitute commodities. Moreover, the Commission should first be required to demonstrate whether a percentage of deliverable supply is even the appropriate metric upon which to base a limit for a given commodity. For example, the CFTC's approach to deliverable supply fails to account for (i) substitute commodities, and (ii) supply that is "available" to market participants but possibly not "deliverable" because it has not been warehoused and certificated.

Second, assuming the Commission is able to demonstrate an appropriate relationship between some percentage of deliverable supply for a given commodity and the concerns the Commission seeks to address with position limits, the Commission should identify a measure of deliverable supply that provides market participants with certainty. The proposed methodology for determining estimated deliverable supply is insufficiently defined to afford the opportunity for meaningful comment. Under the Proposal, the CFTC may "rely" on its own estimates of deliverable supply, but the Proposal does not indicate how the CFTC would arrive at its own

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111 The Proposal includes several alternatives for a conditional spot-month limit that would permit, in different variations, a trader to hold a larger position in the spot month (up to five times the proposed "regular" spot-month limit) if limiting itself to cash-settled contracts.

112 Even assuming the Commission could identify a level that was appropriate across several commodities, Pirrong notes: "[A] single long trader must have a position in excess of deliverable supply to execute a corner. Thus, a 25 percent limit is unnecessarily low to prevent manipulation by a single trader." Infra Annex B, at 9 (footnote omitted).

deliverable-supply estimates.[113] The Commission notes that in the alternative to relying on its own estimate, it could rely on the estimates provided by DCMs—which are required, under the Proposal, to submit such estimates to the CFTC. If the CFTC were to articulate how it intends to develop its own estimates of deliverable supply, we would be in a better position to comment on this approach. For that reason, the Commission should always publish its estimates of deliverable supply for public review and comment – and the CFTC should always identify the data that it uses (even if that data is not publically available) to reach its estimates. Moreover, the CFTC should permit market participants to challenge the CFTC's estimated levels by demonstrating that actual market supplies are different. As it is written, the current Proposal does not provide a basis for comment.

Third, setting initial spot-month limits at existing exchange limits is arbitrary in that it ignores that traders will hold positions across DCMs and in swaps, whereas the only reason existing DCM limits were established by the DCMs was to monitor traders in a single futures market. The existing exchange limits have not been calibrated to the purpose for which the CFTC seeks to apply them—setting a ceiling on the spot-month positions that a trader can hold across *all* exchanges for futures, options, and swaps. Given the potential costs and burdens associated with complying with a specific position limit, it is irresponsible to try to implement a short-hand approach to setting initial limits.

As has previously been expressed in addressing several other issues throughout this comment letter, it is not impossible for the CFTC to meet the requirements of CEA Section 4a(a) as they relate to necessity and appropriateness. But the incomplete rationales presented in the Proposal clearly demonstrate that the Commission has not yet developed an approach to position limits that is compliant with Congress's direction.

5. Cross-Commodity Netting

The Proposal would recognize certain positions as bona fide hedging positions (and thus entitled to an exemption from position limits) even when based on a commodity other than the commodity giving rise to the exposure being hedged, *i.e.*, a cross-commodity hedge. In the same way, the Commission should permit cross-commodity netting (separately from cross-commodity hedging). Recognizing cross-commodity netting is vital to accurately reflect the actual trading practices used by market participants and the practical business realities faced by market participants.

We understand the Commission's concerns relating to the requisite level of correlation needed to support cross-commodity hedging, and we agree that a market participant should be required to

[113] Even if the Commission were to determine to rely on its own estimates of deliverable supply, we believe that the CFTC should always seek input on the methodology and data sources used to make its estimates. Specifically, the CFTC should include a requirement that it consult with both exchanges and commercial market participants regarding the scope of deliverable supply of each commodity. If the CFTC fails to include input from these constituents, in determining deliverable supply, the spot month position limits may fail to reflect accurate or reliable levels of estimated deliverable supply.

demonstrate some reasonable degree of correlation. Either a threshold correlation factor (for example, 60%), or an approach that would permit netting on a pro rata basis, to the extent of demonstrated correlation, would ensure the Commission that this type of netting was being used in an appropriate manner. Ultimately, position limits should be based on a trader's ability to affect the market, and true net positions of an individual trader, taking into account cross-commodity netting, most accurately reflect the potential market impact.

6. Cross-Border Applicability

As demonstrated by the Commission's staggered approach to the cross-border application of the majority of its Dodd-Frank swaps rules, market participants and the market are harmed when a single set of market activity is subject to conflicting regulatory regimes.[114] A lack of clarity creates uncertainty, and at times conflict, in determining which law applies to a given transaction or position. However, in most instances, the uncertainty and lack of clarity can only be ultimately resolved by the efforts of the respective regulators, working together, to reach a harmonized and complementary approach, particularly for markets that are as global in scope as the derivatives markets. Therefore, the CFTC should refrain from imposing position limits until it has consulted with foreign regulators and is prepared to harmonize efforts to avoid fragmented liquidity and increased volatility. The Proposal does not indicate that the CFTC has undertaken any effort to harmonize its approach to position limits with foreign regulators.

The Dodd-Frank amendments to the CEA direct the CFTC to analyze and consider whether position limits will (or may) result in non-U.S. market participants moving transactions outside of the U.S. It was irresponsible for the Commission to suppose that it need not also fully consider these issues in the process of proposing the rules. In fact, Section 4a(a)(3)(C) requires the CFTC to expressly ensure, prior to imposing limits, that any limits to be imposed by the Commission will not cause price discovery in the commodity to shift to trading on the FBOTs.

7. Eligible Affiliates

To ensure that the proposed exemption for an "eligible affiliate" covers sister affiliates, the Commission should define it consistently with the definition of "eligible affiliate counterparty" under CFTC Rule 50.52. The exemption should not only apply to subsidiaries but should also apply to sister affiliates. The Commission's speculative position limits rules should treat aggregated entities, including sister affiliates, as a single person.

8. Trade Options Excluded from Position Limits

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114 See, e.g., Derivatives: Global Convergence Becomes Global Confusion, Closer Look (PwC, New York, N.Y.), Sept. 2013, available at http://www.pwc.com/en_US/us/financial-services/regulatory-services/publications/assets/pwc-closer-look-derivatives-cross-border-secure.pdf; Gina Chon & Philip Stafford, CFTC Extends Reach over Foreign Companies, FT.com (Dec. 21, 2013, 12:14 AM), http://www.ft.com/intl/cms/s/0/be7a484a-69ae-11e3-aba3-00144feabdc0.html ("The CFTC's latest actions could cause confusion, especially where regulations contradict one another.").

We do not believe the CFTC should require market participants to take trade options into account for purposes of position limits, regardless of whether a trade option falls under the definition of "referenced contract." Trade options are entered into by commercial market participants, in connection with their business, and the option must result in physically delivery if exercised. The Commission has not identified any rationale for including, in the current Proposal, these contacts, which are typically used to secure a source of physical supply for a commercial user of a commodity.

9. Compliance Period

To the extent the Commission adopts a final position limits rule, the Commission should provide an extended compliance period during which market participants will have time to assess their operations, build compliance programs, and modify trading practices to comport with the rules. We believe the transition period should be at least nine months and it should be clearly set forth in any final rule issued by the Commission. Moreover, the Commission should commit, in the final rule, to providing CFTC resources to assist market participants in understanding and applying the rules, by reviewing and responding to pubic inquiries, during the nine month compliance period.

Beyond a general nine month compliance period following the issuance of final rules, the Commission should also further delay compliance for any position limit for which the Commission does not have reliable data on which to set the limit levels. As demonstrated in our comments above, we believe the Commission does not have reliable data from which to set any of the proposed position limits, and so we urge the Commission to delay compliance with rules, even if adopted as final, until the Commission is able to receive and evaluate the scope and quality of data that is required to set the limits at levels that are justifiable and will not harm market participants.

10. Referenced Contracts; Basis Contracts

The Proposal will impose position limits on both core referenced futures contracts (which are 28 specific futures contracts) and an unspecified category of referenced contracts. Instead of defining referenced contracts with a general, non-specific, and unbounded qualitative definition (*i.e.*, those swaps that are *economically equivalent* to a core referenced futures contract), the CFTC should publish an exclusive list of referenced contracts. The Proposal was accompanied with the Commission Staff's referenced contract workbook,[115] which attempts to provide a non-exhaustive list of referenced contracts. We believe the Commission could remove a considerable amount of uncertainty, while at the same time establishing realistic boundaries within which it can begin to pursue the statutorily required necessity and appropriateness findings, by identifying a fixed list of Referenced Contracts to which position limits may apply.

In addition, for purposes of the definition of basis contracts, which are excluded from position limits, the Commission should expand the list of commodities in proposed Appendix B that are

[115] Position Limits for Derivatives, 78 Fed. Reg. 75680, 75834–35 (Dec. 12, 2013) (to be codified at 17 CFR pt. 150 app. B).

substantially the same as a core referenced futures contract. The scope of commodities that are substantially the same in proposed Appendix B should reflect the commercial practices of market participants, and the Commission should permit market participants to identify additional contracts to add to Appendix B as appropriate. We specifically request that the CFTC expand the list to provide that:

- Jet fuel (54 grade) is substantially the same as heating oil (88 grade), and
- WTI Midland (Argus) vs. WTI Financial Futures is listed for Light Louisiana Sweet (LLS) Crude Oil.

11. SEFs

The Commission should exempt SEFs from any requirement to enforce compliance with federal limits or to establish SEF limits for contracts subject to federal limits. As an alternative to setting position limits, SEFs should only be required to provide data to the Commission to assist it in monitoring compliance with federal speculative position limits. Because the SEF environment is still in the developmental stages (as the Commission only recently finalized its SEF rules), and because participation on SEFs is still in the very early phases, the Commission should be cognizant to avoid the risk of harming the development of these markets. Rather, the Commission should not impose position limits requirements on SEFs until such time as the Commission has been able to develop an understanding of the SEF market and the needs of market participants that use SEFs. For example, the CFTC should refrain seeking to impose position limits requirements on SEFs until the Commission has the ability to examine data related identifying (i) the contracts being traded on SEFs (including volume and liquidity levels), and (ii) the market participants that are using the SEFs to trade.

B. Hedge Exemptions

The Proposal inappropriately narrows the availability of hedging exemptions compared to those existing under current Commission practice. We believe that any final position limits rule must include a defined process for seeking additional hedging exemptions as well as additional enumerated hedge exemptions beyond the narrow set of hedging positions identified in the Proposal.

1. Process for Recognition of Additional Bona Fide Hedging Positions

The CFTC should include an express provision creating a process that enables market participants to seek Commission and/or staff recognition of additional bona fide hedging positions that meet the statutory definition of "bona fide hedging position" but that are not enumerated in the rule. This mechanism is available under existing CFTC rules,[116] yet the Commission inexplicably omits such a procedure from the Proposal. Multiple non-enumerated hedging exemptions that nonetheless meet the statutory definition of a bona fide hedging position have been relied upon by market participants and have not been the cause of

[116] Currently, under CFTC Rule 1.47, the CFTC Staff has 30 days to respond to a new request for a non-enumerated hedge position and 10 days to respond to an amendment to an existing request.

manipulation or other concerns. In addition, any final rule should provide a specific process pursuant to which market participants may request that the CFTC use its general position limits exemptive authority under CEA Section 4a(a)(7) to exempt other positions from the position limits rules on a case-by-case basis.

In establishing a process for the recognition of additional bona fide hedging or exempt positions, the CFTC should also allow for a consideration of whether exemptions may be appropriate for a specific class of traders (or commodities) even when not generally appropriate for all traders or all commodities. For example, and as discussed below, commenters have already identified several instances of hedging activity that the CFTC should continue to explicitly categorize as bona fide hedging positions, but these requests are inexplicably rejected in the Proposal.

2. Unleveraged, Passive Investment Entities.

In the context of any final rule, the Commission should provide for a larger position limit (whether by exemption, or in setting the actual limits) for traders that qualify as passive, unleveraged investment entities.[117] The presence of these entities in the markets provide the low-risk liquidity that facilitates hedging for smaller commercial entities,[118] and they do so in a way that permits innovation and growth in industries where new or lesser established market participants have historically been constrained by an inability to manage commodity price risks.[119] Without the passive interests maintaining a long-side presence in the commodity markets, the hedgers may be unable to find sufficient liquidity to hedge their own price exposures.

3. Cross-Commodity Hedging Exemption

The Proposal would unnecessarily restrict cross-commodity hedging by imposing unreasonable and impractical constraints.[120] As discussed above, cross-commodity hedging is a critical component of the risk-management practices used in several industries. For example, market participants with an exposure to jet fuel are often able to hedge that exposure in the most efficient way by entering into offsetting positions in crude oil contracts, which have a highly liquid market as well as a pricing structure that is largely correlated with the pricing of jet fuel.

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117 As Pirrong notes in his attached paper, "[T]he [proposed] rule applies to other entities that are very different and do not pose the same risks [as leveraged entities with a single decision maker]." Infra Annex B, at 3.

118 See Sanders & Irwin, supra note 63, at 48 ("[L]imiting the participation of index investors would rob the commodity futures markets of an important source of liquidity and risk-absorption capacity at a time when both are in high demand.").

119 See the demonstration of this in the context of energy markets by Philip Verleger, demonstrating that as passive longs leave the market the hedgers (i.e., natural shorts) lose the ability to hedge. Infra Annex A, at 3–9.

120 See the discussion below in Annex B, at 7–8, demonstrating that the CFTC's proposed correlation methodology in the context of cross-commodity hedging is unworkable.

In the same way, natural gas is a primary feedstock for electricity and in many instances a market participant hedges its exposure to electricity with natural gas derivatives.[121] However, the Commission's proposed correlation formula is overly strict, has no empirical basis, and if applied as a final rule would not even permit cross-commodity hedges involving derivatives on certain essentially identical commodities (*e.g.*, on Brent vs. WTI crude oil).

In addition, the CFTC should retain exemptions for referenced contracts that are physical-delivery contracts held into the spot month when they are held as a cross-commodity hedge and held either held in connection with exposure to a physical commodity; or in connection with meeting unfilled anticipated requirements. To force market participants out of a cross-commodity hedging mechanism in the spot-month is inconsistent with the Commission's general recognition of the fact that, for certain commodities, the most efficient hedging mechanism is a cross-commodity hedge. To withdraw the exemption in the spot month would essentially prohibit the ability to hedge in those instances.

4. Anticipatory Hedging; the Working Group Petition

The Proposal does not recognize the important role of merchandizers and their need to engage in anticipatory hedging. The Proposal similarly includes unnecessary limitations on the ability of commercial market participants to hedge. We support each of the requests presented by the Working Group of Commercial Energy Firms (the "Working Group") and discussed by the Commission in the Proposal.[122] Specifically, and in addition to the exemptions discussed above, we believe that any final rule should include enumerated exemptions for each of the following classes of referenced contracts (which were not included in the Proposal):

- Contracts used to lock in a price differential where one leg of the underlying transaction is an unfixed-price commitment to buy or sell a physical energy commodity, and the offsetting sale or purchase has not been completed;
- Contracts used to hedge exposure to market price volatility associated with binding and irrevocable fixed-price bids or offers; and

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121 In his paper, Pirrong adds: "[T]he Proposed Rule presents estimates of the correlations between changes in the spot prices of electricity in several markets and changes in the nearby NYMEX natural gas price, finds that these correlation are well below [the CFTC's proposed threshold], and concludes that natural gas futures would not be permitted as a cross hedge of electricity prices. . . . This fundamentally misunderstands how many cross hedges work, and the economics of commodity prices. Hedgers are often hedging forward prices/exposures not spot prices. In the case of electricity, for instance, in January, 2014 a generator may be hedging the price of power for delivery in July, 2014. If so, the firm is likely to use the July gas futures contract as a hedge. What's more, the correlation between the July gas futures price and the July power forward price will be different than, and likely far higher than, the correlation between the spot power price and the nearby gas futures price." Infra Annex B, at 7–8 (citation omitted).

122 The petition is available at: http://www.cftc.gov/stellent/groups/public/@rulesandproducts/documents/ifdocs/wgbfhpetition012012.pdf. The Commission discussed the petition at Position Limits for Derivatives, 78 Fed. Reg. 75680, 75719 *et seq.* (Dec. 12, 2013).

- Contracts used to hedge a physical transaction that is subject to ongoing, good-faith negotiations and that the hedging party reasonably expects to conclude.

In addition, the Commission should clarify that the "economically appropriate" test, for hedging a physical commodity, does not require the netting of physical positions across a group of affiliated companies or across an enterprise. In the Proposal, the CFTC appears to agree, saying, "The Commission affirms that gross hedging may be appropriate under certain circumstances, when net cash positions do not measure total risk exposure due to differences in the timing of cash commitments, the location of stocks, and differences in grades or types of the cash commodity being hedged."[123] However, the Proposal then says: "In order for a position to be economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, the enterprise generally should take into account all inventory or products that the enterprise owns or controls, or has contracted for purchase or sale at a fixed price."[124]

This approach ignores the Commission's earlier affirmation and also ignores the way that business lines are managed within a commercial enterprise. For example, an enterprise may include both an oil and gas production unit, as well as a refining unit. These two business are naturally on opposite sides of the physical market, and it is impractical to require one business to hedge only after incorporating the physical commodity position of an unrelated business venture.

A failure to include these exemptions, or to appropriately permit hedging activity based on physical exposures of individual business lines within a corporate group, would unnecessarily restrict or prohibit the legitimate hedging activity relied upon by commercial entities in conducting their business. In addition to supporting the rationale for these exemptions as put forth by the Working Group, we urge the Commission to recognize that any unnecessary or reflexive limitation on the scope of the definition of bona fide hedging will result in a direct and significant inability of a commercial entity to plan, innovate, and grow.

For similar reasons, the CFTC should retain a bona fide hedging exemption for unfilled storage capacity. The Original Position Limit Rules included an exemption for anticipated merchandising transactions that were "no larger than the amount of unfilled storage capacity currently" or anticipated being available "during the hedging period."[125] As with each of the exemptions discussed in this letter, if the Commission intends to go forward with imposing position limits, it must only do so in a way that does not unduly harm market participants and markets. By limiting the ability of a market participant to engage in derivatives activity (by limiting the availability of hedging exemptions), the Commission will directly limit the ability of market participants to conduct commercial business.

5. Orderly liquidation

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123 Id. at 75709.

124 Id.

125 See Position Limits for Futures and Swaps, 76 Fed. Reg. 71626, 71646–47 (Nov. 18, 2011), vacated, ISDA v. CFTC, 887 F. Supp. 2d 259 (D.D.C. 2012).

The Commission should not apply a negligence or "ordinary care" standard for purposes of determining whether hedging positions have been established, maintained, and liquidated in an orderly manner. The standard should instead allow the Commission to take into account the circumstances that potentially give rise to an allegation of failing to establish, maintain, or liquidate a position in a disorderly manner, including rapidly changing market conditions. In addition, at a minimum, the CFTC should apply the same standard for disallowing treatment of a position as a bona fide hedging transaction for purposes of the orderly trading requirement as it will apply under the disruptive trading practices rule.

6. Reporting requirements

With respect to the proposed reporting forms that will be required to claim a bona fide hedging exemption, the Commission should first re-evaluate the cost that these forms will impose on market participants. The Commission should directly analyze the costs the forms will impose, including requiring new compliance programs, training staff on the requirements of the forms, purchasing or modifying data management systems in order to accommodate the requirements of the forms, and storing the data required to be reported.[126]

III. Conclusions

As outlined in this letter, the Commission once again seeks to rely on an improper and impermissible interpretation of its position limits authority. In addition, the Commission fails to meet the clear requirement of the statute to determine that position limits are appropriate and necessary to diminish, eliminate, or prevent the burden of excessive speculation, and that the proposed limits are warranted, on a commodity by commodity basis. Finally, the Commission has failed to meaningfully evaluate the costs and benefits of its Proposal. As a consequence of these legal deficiencies, we continue to urge the CFTC to postpone adoption of the Proposal until after it has collected, analyzed, and presented the data needed to satisfy the standards set forth by Congress in delineating the CFTC's statutory position limits authority. Moreover, the Commission should also refrain from imposing position limits until it has conducted a full assessment of the cost and benefit impact that those limits will have on markets. This approach is consistent with the CEA's unambiguous requirements and would serve the congressionally-recognized purpose of protecting liquidity and price discovery in the derivatives markets and, thus, safeguarding the ability of both end-users and their counterparties, throughout the U.S. economy, to use those markets to hedge against risk and plan for and facilitate future business growth.

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

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[126] For example, as noted above, we understand that the real estimated cost to develop the information technology systems necessary to track and report positions across multiple deal capture systems will be approximately $750,000 to $1,000,000 per firm.

Sincerely,

Robert Pickel
Chief Executive Officer
ISDA

Kenneth E. Bentsen, Jr.
President & CEO
SIFMA

cc: Honorable Mark P. Wetjen, Acting Chairman
Honorable Bart Chilton, Commissioner
Honorable Scott D. O'Malia, Commissioner
Stephen Sherrod, Senior Economist
Riva Spear Adriance, Senior Special Counsel
David N. Pepper, Attorney-Advisor

Attachments: ANNEX A
Philip Verleger paper

ANNEX B
Craig Pirrong paper

Philip K. Verleger, Jr.
540 Fox Run Drive
Carbondale, CO 81623

February 10, 2014

Ms. Melissa Jurgens
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, DC 20581

Re: Notice of Proposed Rulemaking – Position Limits for Derivatives (RIN 3038-AD99)

Dear Ms. Jurgens:

I am a scholar who has followed the development of energy policy and energy markets for forty-two years. I have published two books, including one analyzing the behavior of the evolving energy commodity market,[1] and numerous articles in professional journals. A number of these papers are on the interrelationship of physical oil markets and energy commodity markets, such as the effects of actions taken by policymakers on physical price behavior. I have noted often that actions taken by policymakers affect physical price behavior. I have also written that these regulations affect prices in energy commodity markets.

I have also issued a monthly report on energy markets through my own firm for thirty years, as well as a weekly commentary for eighteen years. These publications are purchased by organizations such as the International Energy Agency (the IEA), by various oil-producing countries, by large oil consumers, and by government agencies in several nations. I have also testified in multiple major oil-price-manipulation disputes and published articles on these cases.

I joined Drexel Burnham Lambert's commodity division in 1982, where I took part in creating the WTI futures contract, and I have since taught at the University of California-Santa Barbara, Yale University, and the University of Calgary, where I held the David Mitchell professorship at the Haskayne School of Business. I retired from teaching in 2011.

In 2010, I became the first economist in the United States (or the world for that matter) to write of the United States becoming energy independent. And my work has recently been recognized

[1] See Philip K. Verleger, Jr., "The Evolution of Oil as a Commodity," in R.L. Gordon et al. (eds.), *Energy: Markets and Regulation* (Cambridge, MA: MIT Press, 1987), pp. 161-186.

by the Group of 30, an organization of the world's leading central bankers and macroeconomists.[2]

I have been retained by ISDA for the purpose of addressing position limits and the impact of the Commission's proposal. Accordingly, I have reviewed the CFTC's recent notice of proposed rulemaking on position limits for derivatives.[3] In this paper, I provide an analysis of the CFTC's recent position limits proposal, including the likely costs that will result from the implementation of the proposed limits. Specifically, I believe the proposing release raises the following significant issues:

- The CFTC has failed to conduct a meaningful (much less, adequate) consideration of the costs and benefits of the proposed rules. And the CFTC failed to incorporate any economic analysis to evaluate the potential impact of the proposed limits on markets and market participants.
    - The CFTC has not identified or demonstrated that excessive speculation exists in markets, thus diminishing at the outset the possibility the limits would provide a benefit in the form of limiting excessive speculation; and a review of energy markets over the preceding five-plus years similarly fails to reveal any evidence of excess speculation.[4]
    - Historically, unwarranted price fluctuations are due to a confluence of contributing factors, sometimes including weather, geopolitical events, and changes in industry structure. As discussed below, the high energy prices observed in 2008 are attributable to environmental regulations. And the decreases in energy prices that followed 2008 are attributable to innovations in the United States energy sector, largely facilitated by the availability of the swaps markets for commercial firms to hedge their price exposures, secure financing, and expand their energy exploration efforts. A major cost of the proposed limits that is not considered by the CFTC is the limitation they will place on commercial firms that rely on the derivatives markets for such hedging, planning, and financing purposes.
    - Although the analysis in this paper is focused on the energy markets, which are my field of concentration, most physical commodities markets are subject to conditions and dynamics similar to those in the energy markets. Therefore, the position limits rule should be expected to have adverse effects in the other

[2] The G30 is an organization of leading central bankers and macroeconomists. Its past chairman was Paul Volcker; its present chairman is the European Central Bank's former head Jean-Claude Trichet. The Bank of England's current governor and the ECB's current president are also in the group.

[3] See CFTC, "Position Limits for Derivatives," *Federal Register* 78, December 12, 2013, pp. 75680-75842.

[4] As a specific example, even in spite of record cold temperatures in the current winter, we are not seeing the extreme price volatility / price disruptions for natural gas that we had witnessed during similar conditions in prior years. This is directly due to the orderly functioning of swaps and futures markets, which in turn, as described in this paper, support the ability of commercial market participants to hedge price risk, obtain financing, and grow their output levels—all mitigating price increases and price volatility. For example, see Russell Gold, "Fracking Boom Keeps Home Heating Bills in Check: Prices of Natural Gas Avoid Volatility of Past Winters," *Wall Street Journal*, January 28, 2014 [http://goo.gl/q3m2cN].

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covered commodities markets that resemble the effects I project for the energy markets.

- The proposed limits, particularly those for the non-spot month, if in effect, would produce a chilling effect on swaps market participants, very likely leading to, among other things, higher energy prices than those observed in the absence of position limits. This is another major cost that the CFTC has failed to address, compounding the absence of any identified benefits in the proposal.
  - The proposed rules will unnecessarily restrict the trading activity of certain market participants, thus restricting liquidity.
  - The proposed rules, including the proposed framework for bona fide hedging, would unduly restrict the ability of commercial firms to use futures and swaps to hedge.
- By restricting the ability of commercial firms to use futures and swaps, the rules directly harm the ability of those firms to conduct their business, obtain financing, and plan for future growth.
- As a general matter, position limits should not apply to cash-settled contracts. Traders holding cash-settled contracts do not have any ability to influence the physical-market prices of a commodity.
- Finally, I believe that exchanges are the appropriate mechanism through which position limits, if any, should be set. Exchanges currently set limits, and exchanges have the expertise and experience, in specific markets and for specific commodities, that is required to set limits. Moreover, exchanges have the ability to adapt and respond in a very quick and efficient manner when their limits need to be recalibrated.

I. Costs and Benefits of the CFTC's Position Limits Proposal

A. Benefits of Energy Swaps and Futures Would Have Been Jeopardized if the CFTC's Position Limits Proposal Had Been Implemented.

Reviewing the proposed position limits release from the perspective of an economist, it is striking that the CFTC has not attempted to evaluate the real costs of the proposal or to address the fact that the proposal fails to identify any real benefits to either markets or market participants.

The CFTC's proposed limitations on positions taken by passive investors or speculators in non-spot-month contracts, as well the removal of the availability of bona fide hedging exemptions granted to swap dealers trading opposite such investors, would have adversely affected producers, had they been in effect in recent years. The cost of the proposed regulations, had they been in effect in 2013, would have been higher oil and natural gas prices. As discussed below, I estimate from a "but-for" model that prices would have been $15 per barrel higher in 2013 had the regulations been in effect. The cost to American consumers would have been roughly $100 billion. Because oil is a global commodity, the cost to world consumers of the regulations would have been on the order of $500 billion. The CFTC's proposal does not consider this impact of the proposed position limits on oil prices.

Over the past decade the price of oil has increased and then stabilized. As indicated by my past publications and testimony, this increase is largely attributable to economic fundamentals—supply not increasing fast enough to match demand. Further, oil prices would have continued to increase if U.S. oil and gas production had not increased as much as it did in the last two years.

As described below, this rapid increase in oil and gas production was possible because of energy futures and swaps. Because the CFTC's proposed position limits would have impeded the growth of U.S. oil and gas production, and could do so again when a similar disconnect between supply and demand arises, such limits would be costly to commodity markets.

Limitations on Energy Supplies and Environmental Regulations Allowed Oil Prices to Soar from 2004 to 2009; These Price Movements Have Never Been Connected to Excessive Speculation

Excessive speculation has not been observed in the energy markets. In 2004, I published an article in *The International Economy* warning that oil could go to $60 per barrel.[5] At the time, prices traded near $40. Two years later, I warned in the same publication that prices could rise to $100.[6]

In these pieces, I described the two factors then driving prices: (i) a failure to expand refining capacity to keep pace with growing demand and (ii) environmental regulations. In the 2006 article, I focused on new regulations that required sulfur to be removed from diesel fuel. I noted that these rules could easily push crude above $100 because the global refining industry lacked capacity to comply with regard to much of the oil in world trade, particularly crudes from the Middle East. In neither instance did I identify or observe a risk of excessive speculation as a factor contributing to potentially higher prices.

In December 2007, I testified before the United States Senate, warning that prices could soon rise above $130 per barrel. (They were at $90 then.) I argued that environmental regulations and U.S. Department of Energy policies regarding the U.S. Strategic Petroleum Reserve (the SPR) would push prices higher, not speculation.[7] In 2009, economists at the IEA validated my

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[5] Philip K. Verleger, Jr., "Why Oil Could Go to $60," *The International Economy*, Fall 2004 [http://goo.gl/rULGXf]. I am an editor at *The International Economy*, which is distributed to central bankers and heads of major financial institutions. The publication comes out quarterly and regularly features original articles by leaders of central banks and major macroeconomists.

[6] Philip K. Verleger, Jr., "Hundred Dollar Oil, Five Percent Inflation, and the Coming Recession," *The International Economy*, Winter 2006 [http://goo.gl/GzQl7I].

[7] See "Prepared Testimony of Philip K. Verleger, Jr. to the Permanent Subcommittee on Investigation of the U.S. Senate Committee on Homeland Security and Governmental Affairs and the Subcommittee on Energy of the U.S. Senate Committee on Energy and Natural Resources," December 11, 2007 [http://goo.gl/WmfNSM]. In my testimony, I was particularly critical of a U.S. DOE policy to sequester sweet crude for the SPR at a time when world refiners were desperate for such supplies. Refiners lacking capacity to remove sulfur from crude could produce low-sulfur diesel from sweet crude that met new, tighter EU regulations. They could not produce the product from Middle Eastern crudes. Thus over the following year (2008), cargos of Iranian crude containing large amounts of sulfur could not be sold even as sweet crude prices rose to $140 per barrel.

contention.[8] However, by that time the myth of speculation boosting crude prices had been accepted by most policymakers.

I testified before the CFTC on August 5, 2009, on what caused the crude oil price increase in 2008. In my remarks, I provided a detailed explanation of the reasons, observing that environmental regulations that require ultra-low-sulfur diesel production in Europe had pushed up the price of light sweet crude because refiners lacked capacity to remove sulfur. My views were ignored.

Therefore, and although the CFTC does not identify any specific benefits of its proposal, it is in no way permissible to conclude that position limits are required to cure the consequences of excessive speculation in the oil markets.

Energy Derivatives Recently Helped U.S. Oil and Gas Production to Grow to Meet Demand

The CFTC's proposal is not only lacking in foundation but could be positively harmful to energy markets. In my 2009 testimony, I also spoke to the beneficial role of energy derivatives in linking supply of oil and gas to changes in demand. Specifically, I made the following point:

> **Futures and swaps contracts provide an important mechanism for promoting energy independence by reducing the cost of investing in oil and gas exploration.**

In my CFTC testimony, I also made this statement:

> The commission seems inclined to impose position limits on banks and financial institutions that use futures [and swaps] markets. This would be a mistake because it would raise the cost of investing in oil and gas development, thus further frustrating the nation's effort to achieve energy independence.

I went on to explain that many of the firms engaged in exploration and production were relatively small. These companies needed to use derivatives to hedge in order to conduct their exploration efforts. I detailed the success of one small company, Newfield, which is now a major player in U.S. exploration and production.

In my testimony, I also observed that firms engaged in exploration and production required the banks as partners; specifically, the banks and other parties were needed to take the opposite market positions from the exploration and production firms.

My view that smaller firms would contribute to a large increase in U.S. oil and gas production has been confirmed. When I testified in 2009, the U.S. Energy Information Administration (EIA) projected in its annual report that 2013 U.S. crude production would total 5.97 million barrels per day. In December 2013, the EIA issued a new long-term outlook. In that report, the agency noted that U.S. production in 2013 had been 7.72 million barrels per day, not the projected 5.97 million barrels, a difference of 1.75 million barrels per day or about thirty percent. The unanticipated

[8] IEA, *Medium-Term Oil Market Report*, June 2009, p. 106.

increase was due almost entirely to growing production from North Dakota and the Eagle Ford shale and activity in the Permian Basin. That growth came from the efforts of independent producers expanding their exploration efforts and thus raising output.

The EIA also published a projection of natural gas production in its 2009 annual report. It forecasted 2013 natural gas production of 19.45 trillion cubic feet from U.S. wells. The updated outlook issued in December 2013 put U.S. natural gas output at 21.98 trillion cubic feet, a difference of 2.53 trillion cubic feet. The unexpected production, as with crude, resulted from the efforts of the smaller firms that aggressively expanded their exploration efforts and raised their output.

The increase in U.S. oil and gas output is directly attributable to the smaller independent exploration and production companies that kept pursuing development of U.S. onshore resources long after the larger integrated companies abandoned it. The companies commonly associated with this effort, among others, are Chesapeake Energy, Continental Oil and Gas, EOG Resources, XTO Energy (XTO merged with ExxonMobil in 2010 but has remained effectively an independent), and a few others.

To demonstrate the impact of this group, I have examined the output of just ten companies that contributed to the increase output levels recognized by the EIA (Crude Oil is shown in Table 1; Natural Gas is shown in Table 2).

Table 1. Incremental Crude Oil Production for Ten Independent Companies in 2009 and 2013 (Million Barrels)

Firm	2009	2013:Q1
EOG	47.9	204.3
Cabot Oil and Gas	2.2	5.8
Continental Resources	27.5	70.5
Chesapeake Energy	32.3	125.8
Occidental Petroleum	271.0	264.0
Pioneer Natural Resources	25.0	74.3
Whiting Petroleum	42.2	54.0
Murphy Petroleum	17.1	133.5
Apache	89.1	156.8
Devon	46.6	75.1
Total	600.9	1,164.1
Total per Day	1.6	3.2

Source: The Brattle Group; PKVerleger LLC.

Table 2. Incremental Natural Gas Production for Ten Independent Companies in 2009 and 2013
(Million Cubic Feet per Day)

Firm	2009	2013:Q1
EOG	1,134	920
Cabot Oil and Gas	266	760
Continental Resources	59	174
Chesapeake Energy	2,287	2,258
Occidental Petroleum	635	799
Pioneer Natural Resources	353	384
Whiting Petroleum	80	54
Murphy Petroleum	54	432
Apache	666	2324
Devon	2,035	1,958
Total	7,569	10,063
Annual Total (Billion CF)	5,525	7,346

Note: Million cubic feet converted to billion cubic feet when annualized.
Source: The Brattle Group; PKVerleger LLC.

Global oil prices would be significantly higher today absent the efforts of explorationists. In particular, crude prices could have been $30 per barrel higher in 2012 and $90 higher in 2013 had U.S. crude oil production not surged unexpectedly as a result of expanded exploration efforts and the related increases in output. This difference highlights a major cost of its proposal that the CFTC has failed to consider altogether: to the extent position limits restrict the ability, in any way, of companies to use swaps and futures to (i) lock in future prices or (ii) obtain financing for continued expansion, there will be a direct impact on energy prices.

I have developed a methodology for predicting changes in crude oil prices linked to global inventory levels. The model accurately predicts the actual crude price trend. I have used the model to calculate the prices that would have obtained without the incremental production obtained as a result of expanded exploration efforts, which were able to be financed by companies using the swaps markets to hedge pricing risks.

That is, a significant portion of the increased oil production from U.S. resources would not have been available had producers been unable to use U.S. derivative markets. Obviously, oil prices would have been higher had the companies been less successful in boosting production.

All these companies have relied on debt and bank loans to achieve output. Most if not all the loans carried covenants requiring the borrowers to hedge future production to protect future cash flows. Thus any limits imposed in the past would have resulted in less drilling, lower incremental oil production, and higher oil prices.

All these companies actively used swaps and futures. All but one relied on swaps and futures to hedge their positions, boosting their forward sales of current and future production using swaps and futures as their output grew. To demonstrate, Table 3 summarizes the growth in this hedging activity between 2009 and 2013 in connection with oil production.

Table 3. Hedging of Crude Oil Production by Ten Independent Companies in 2009 and 2013 (Million Barrels)

Firm	2009	2013:Q3
EOG	NA	35.4
Cabot Oil and Gas	0.4	1.1
Continental Resources	1.6	6.7
Chesapeake Energy	6.0	28.0
Occidental Petroleum	0.3	NA
Pioneer Natural Resources	4.1	59.2
Whiting Petroleum	19.0	15.3
Murphy Petroleum	NA	NA
Apache	30.1	46.1
Devon	28.8	38.0
Total	90.3	229.8
Total per Day	0.25	0.63

Note: Chesapeake excludes exit options.
Source: The Brattle Group; PKVerleger LLC.

The unanticipated U.S. oil and gas production increase in 2013 would have been far smaller had these firms been less successful in exploring for, developing, and producing additional reserves. The companies would not have achieved this success without hedging. Indeed, the position limits proposed in the current notice would have prevented them from achieving what they did.

The existing structure of the swaps and futures market has benefited such firms in at least four ways to date. First, they have not been required to post cash margins on their swap positions. Instead, the intermediaries that have financed their activities have accepted collateral such as commitments for forward volumes, which the intermediaries themselves can hedge.

Second, the explorationists (the firms developing oil and gas reserves) have benefited because neither they nor the intermediaries helping them hedge future output have been constrained by position limits outside the spot month.

Third, the explorationists have been helped by their counterparties' ability to tailor unique derivatives in the swap market that suited the specific hedging needs of each firm. For example, many of the companies that have successfully boosted our gas output have entered basis swaps with various financial institutions to hedge future cash flow.

Fourth, all explorationists have benefited indirectly because passive investors such as retirement funds have taken long positions in commodities through the swap markets.

It is this fourth activity that would be most directly affected by the proposed rule. Institutions such as the California Public Employees Retirement System (CalPERS) have accepted the view popularized by Gorton and Rouwenhorst in "Facts and Fantasies about Commodity Futures" in which the authors asserted that investors should diversity portfolios by investing in commodities.[9] They recommended building a portfolio of commodity futures and then holding the futures for a long period by rolling contracts from one month to the next.

Indeed, commodity market participation included a significant increase in investor participation from 2004 to 2009. The excitement engendered by the two authors also prompted the creation of commodity exchange-traded funds (ETFs) such as United States Oil Funds.

The excitement and cash inflows would almost certainly not have been as great had position limits on swap participants existed at the time because growth prospects would have been limited. Position limits, whether binding or not, would have discouraged investment entrepreneurs from focusing on the commodity sector. Limits would have also discouraged firms from marketing commodity-based ETFs to investors and discouraged pension fund managers from considering commodities as an investment option.
The existence of limits and the possibility that they might be tightened would certainly have discouraged investment banks from devoting the resources to create and market assets designed to reflect movement of commodity prices. Innovators such as the United States Oil Fund would have been less likely to create and market their financial products.

The threat that position limits might constrain their activities would likely have caused some who used swaps to obtain commodity price exposure (taking long positions in commodity swaps as recommended by Gorton and Rouwenhorst) to instead pursue more traditional assets or, if excited by commodities, buy real assets. (Some pension funds did this by investing in real assets such as forests and oil reserves.)

The reduced activity of passive investors would have adversely affected investment in the oil and gas industry. As noted above, many of the companies that contributed to the unexpected surge in oil and gas production have been very active users of derivatives. These firms hedge future cash flows to remain in compliance with loans advanced to support their exploration activity. Their borrowings increase with their success. Their positions in derivative markets, particularly swaps, also increase as their production and borrowings increase. Reduced buying by passive investors would have raised the cost and likely limited the ability of these firms to hedge their positions.

B. The Position Limits as Proposed Would Likely Raise Costs and Reduce Liquidity in Global Energy Markets.

Looking ahead, in order to appropriately assess the costs and benefits of the proposed position limits, one must ask whether the position limits will have any impact on global energy markets or any commodity markets for that matter. My answer is they will.

[9] See Gary Gorton and K. Geert Rouwenhorst, "Facts and Fantasies about Commodity Futures," *Financial Analysts Journal* 62, No. 2 (March/April 2006), pp. 47-68. Gorton and Rouwenhorst built off the earlier work of Kenneth Froot, who had advanced the same concept in 1995. See Kenneth A. Froot, "Hedging Portfolios with Real Assets," *The Journal of Portfolio Management* 21, No. 4 (Summer 1995), pp. 60-77 [http://goo.gl/1DKw7M]. However, Gorton and Rouwenhorst had far better timing than Froot, whose research was ignored because Internet stocks were booming at the time.

If in effect today, the position limits would affect the behavior of market participants, including those developing oil and gas, by raising costs. Those writing or buying energy swaps and/or futures would see higher costs whether or not the regulations are binding. The increase in operating costs associated with the recordkeeping and reporting requirements in the regulations would force those exploring for oil and gas to spend more on compliance and to pay more to counterparties to make the latter's participation in the market attractive. The higher costs would modestly increase the costs of drilling associated with the regulations.

The position limit proposal would also discourage market entry. If implemented, the regulations would likely dissuade some parties from participating that might otherwise take long positions in swaps and futures, thereby facilitating more oil and gas exploration. The cash flow from such investments through the swaps and futures market has funded the purchase of commodity derivatives, which provides buyers for derivative positions taken by the explorationists. If the rule is implemented, it will almost certainly raise the cost of hedging for explorationists. It might even make some types of hedging impossible, which would curtail funding for new exploration. The consequence would be lower U.S. oil and gas production and, quite probably, higher global oil and gas prices.

There is no basis, reviewing the CFTC's proposal, to say that these likely costs of position limits have been evaluated. Moreover, with respect to the CFTC's review of the Amaranth case, and based on my experience in observing the energy markets, the costs of the rule for the energy markets will far outweigh any benefit the Commission conceivably could attribute to averting a repeat of the Amaranth incident.

II. Proposals to Improve the Substance of the CFTC's Position Limits Proposal

A. Cash-Settled Contracts Should Not Have Limits.

The CFTC regulations issued for comment propose position limits for cash-settled contracts. One assumes those drafting the proposal believe a market participant accumulating an excessively large position in a cash-settled contract might influence the cash market price.

This assumption is absurd. Cash-settled contracts settle on expiration at the "benchmark" price reported by the benchmark originators. The price quoted is based on transactions in physical markets. Prices quoted in cash-settled markets cannot influence these markets unless the party with a large position in the cash-settled market also has a position in the physical market. Otherwise, those trading in the cash-settled markets are bystanders.

As bystanders, buyers and sellers of cash contracts cannot affect the price of the commodity being traded in physical markets. Furthermore, logic suggests those trading in the physical market would meet any attempt to manipulate the cash contract by bidding against the trader. Their profitable arbitrage would force prices to converge.

Ironically, the proposed regulation could frustrate efficient arbitrage by imposing limits on those involved in the physical market when they trade in cash-settled markets—for example, see the Commission's proposed conditional spot month limit for traders holding cash-settled contracts, which could potentially restrict the conditional limit to only traders that do not hold a position in physically-settled contracts. Thus a firm active in a physical market such as natural gas might be prevented from bidding against a trader who, in attempting to take a large position in a cash-settled natural gas market, causes the futures price of the cash-settled contract to diverge from the prevailing price in the cash market.

While this scenario seems unlikely, given the limits proposed in the draft regulations future reductions in the limits could lead to such problems. To put it bluntly, there should be no limits on cash-settled contracts, given the inability of a participant to influence physical-market prices by trading in the cash-settled market.

B. Exchanges Are the Appropriate Organizations to Establish Limits in Spot Months.

The CFTC errs in its proposal when it seeks to become the organization that sets spot-month position limits for a physically settled contract. This responsibility, currently managed by the exchanges, should be left with the exchanges.

The exchange managers have a far better understanding of the unique conditions applicable to the physical markets for which their organizations offer contracts. Marketers and managers at the exchanges are well aware of the changing characteristics of the delivery market, the ability of individual participants to make or take delivery, and important but often generally unknown changes in the markets' underlying structure understood only by central market participants. Furthermore, the exchanges and their managers have a large economic interest in making sure contracts function well. This means they take every possible step to make sure physical deliveries occur in a way that promotes the contracts' long-term viability and success.

Exchanges are also far more attuned to the seasonal variation in deliveries. This understanding of individual market conditions increases the likelihood that their managers will move quickly if seasonal factors dictate changes in spot-month limits.

Often, when firms take large positions in spot-month contracts, consumers suffer no harm because an exchange responds quickly when the problem arises. Retail prices are therefore not affected. Exchanges can also alter their rules, such as those governing delivery, to reduce the probability of similar events in the future.

Repeat problems tend not to occur once an exchange appropriately alters its rules. The rule changes can also happen quickly. Finally, they can be tailored to meet the market's needs.

The CFTC is not likely to find solutions nearly as good. If the CFTC had set spot-month limits in response to past market disruptions, the levels would have been reduced well below what the market could manage. Furthermore, regulators in Washington would have been unlikely to understand the cyclical nature of delivery volumes in a commodity subject to very large seasonal swings. Most likely one limit would have been imposed for all months. Such an action would have made the contract much less useful.

Further, traders must today disclose their positions in the futures market *and* swap equivalents. A firm applying for exemption from specific limits in the spot month or all other months must also report its swap and futures positions. Again, exchanges can move quickly and appropriately to correct a fault found in their regulations—effectively resolving the issue.

Economic theory—based on the economic interests of the agents offering futures contracts—as well as experience demonstrates that exchanges are well suited to set spot-month contract limits, if any. Exchanges will also be far more attuned to changes in the underlying market than regulators. The absence of knowledge and sensitivity on the regulators' part—as well as the need to follow prolonged regulatory procedures when making changes to limits established by a government agency as opposed to an exchange—will leave markets *more* vulnerable to manipulation, not less, contrary to the goal of the government agencies and the Dodd-Frank Act.

C. Position Limits Should Not Apply to Non-Spot Month Contracts.

The CFTC has proposed limits for all-month and spot-month contracts for participants in swap and future markets. This is a mistake that will adversely affect the ability of commercial participants to use some futures markets to reduce risks associated with their investment activities. Economic activity may be slowed as participants not qualified for hedge exemptions face limits on their ability to take long positions in swaps and as commercial firms are limited by the narrow scope of activity that the CFTC would permit to qualify as bona fide hedging.

The regulations will most likely cause such an effect where markets are unbalanced, i.e., in derivatives markets for physical commodities characterized by a preponderance of hedging shorts or hedging longs. This is a condition that occurs in various crude markets, where the number of participants wanting to hedge through selling is far greater than participants interested in hedging as longs. This imbalance has been cured by the introduction of passive investors, speculators, and hedge funds (referred to here as non-hedging longs).

The emergence of a large number of non-hedging longs that have taken positions in long-deferred contracts has lifted the forward price of crude up, permitting a number of exploration companies to establish hedges for delivery one, two, or even three years forward. These hedges reduce the risks associated with exploration and production, thereby permitting more investment and drilling than might otherwise occur.

The imposition of position limits on non-spot month positions of non-hedging longs can only adversely affect the incentive to invest by removing some buying interest. This is a key cost that the CFTC's proposal fails to identify or consider. Less investment will occur if forward prices are depressed. U.S. oil production will grow at a slower rate to the extent investment is slowed. And global crude prices will be higher to the extent the growth in U.S. production is slower.

Furthermore, it cannot be argued that the regulations will promote increased investment even if it may be argued that the initial non-spot month position limits are high enough (109,000 contracts for crude as an example) to be nonbinding. At best the regulations will have no impact. It is possible, however, that the rules will depress investment and boost crude prices.

Given the conclusion that the rules can only adversely impact production, drive oil prices higher, and impose increased costs on consumers and the global economy, approval of the regulation requires a showing that non-hedging longs taking excessively large positions in non-spot months in physically settled futures contracts can raise the price paid by consumers for the commodity. I know of no example where such a result has been observed.

I do, however, know where purchases of non-spot month contracts in a physically delivered contract led to lower prices for consumers. Following the financial collapse of 2008, banks used the increased liquidity offered by the Federal Reserve to acquire large inventories of distillate fuel oil. Banks were able to do this because futures markets were in contango.

The contango (a condition where the futures price exceeds cash prices) made it profitable to acquire oil inventories. Stocks rose to a twenty-three-year high on the U.S. East Coast, according to data published by the Department of Energy. These stocks were then drawn in early January 2010 when the East Coast experienced severe cold. Prices would not have remained so low had inventories not been high.

The acquisition of stocks was facilitated by the absence of position limits on the physically delivered heating oil contract. Had the proposed regulation been in effect, stocks could easily have been lower and prices higher.

Setting position limits on non-spot-month contracts, in short, will have no positive economic benefits but could have serious economic costs.

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Sincerely,

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Annex B to Position Limit Comment Paper

10 February, 2014

Ms. Melissa Jurgens
Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street NW
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Re: Position Limits

Introduction

1. As a scholar who has followed, and has contributed to, the debate over speculation in commodity markets, I am grateful to have this opportunity to comment on the Commission's Notice of Proposed Rulemaking (NOPR) on Position Limits in Derivatives issued on 12 December, 2013. I have been retained by the International Swaps and Derivatives Association to review the CFTC's proposal and to prepare this paper addressing the Commission's proposal.
2. I am Professor of Finance and Energy Markets Director of the Global Energy Management Institute at the Bauer College of Business of the University of Houston. I have been involved as a practitioner and academic in the futures and derivatives markets since 1986. During that quarter-century, I have conducted and published substantial research on all major commodity sectors, and on the issues related to speculation and speculative position limits. In particular, I have published a book and nine articles on the economics, law, and public policy of market manipulation. I have also written articles on the behavior of commodity prices; this research, which was published as a book in 2011, specifically examines evidence related to the effect of speculation on commodity price behavior. In 2008, I testified at hearings before the House Committee on Agriculture on the effects of speculation on energy prices.
3. In addition to my academic research, I have served as a consultant to major futures exchanges around the world on issues related to contract design, contract performance, and market manipulation. For instance, I was on the Grain Delivery Task Force that re-designed the Chicago Board of Trade's corn and soybean futures contracts in 1997. I have also served as an expert witness in a variety of cases involving energy, agricultural, and metals derivatives, including cases on commodity market manipulation.
4. I have reviewed in detail the Commission's NOPR. Based on this review, I conclude that the Commission's rule is fundamentally flawed, and should be withdrawn. It is fundamentally flawed because its Necessity Finding does not in fact show that position limits are necessary to prevent or diminish sudden and unreasonable or unwarranted price fluctuations. This is especially the case for the any and all month limits. Moreover, the NOPR is flawed because its cost-benefit analysis is severely inadequate. In addition, there are serious flaws in the bona fide hedging exemptions from the limits. Further, the spot month limits are set arbitrarily, and are almost certainly far smaller than necessary to prevent corners or squeezes. What's more, the different spot month limits for delivery-

settled and cash-settled contracts is logically inconsistent, and inconsistent with an understanding of the economics of manipulation.

The Commission's Necessity Finding Fails to Show That Limits Are Necessary

5. Responding to Judge Wilkins's decision setting aside the 2011 Proposed Rule, the Commission has included an extended Necessity Finding. This finding is long, but does not support the Commission's conclusion that the Proposed Rule is in fact necessary to achieve Congress's intent. The analysis supporting the Necessity Finding is based on a grand total of two episodes.
6. One, the Hunt Silver episode of 1979-1980, is a corner. The Commission readily admits this. It says the Hunts cornered the market (75685), and notes that the Hunts stood for large quantities of silver deliveries and this represented the biggest source of demand for silver bullion (75686): standing for massive deliveries is the essence of a cornering strategy. The Commission further states "[t]he Hunt brothers silver episode demonstrates burdens on interstate commerce of corners and squeezes" (75688).
7. The ability of position limits to prevent corners and squeezes could provide a justification for application of these limits during the spot month, although the availability of other means of preventing and deterring corners and squeezes, such as surveillance, exchange emergency actions, and exchange position limits, casts doubt on their necessity. However, a corner or squeeze episode provides no justification of the necessity of imposing position limits outside the spot month. Thus, the Hunt Silver episode cannot be invoked to prove the necessity of any and all month limits.
8. The second example that the Commission invokes to justify necessity is the Amaranth Natural Gas episode of 2006. Although Amaranth engaged in manipulation at the close of trading ("banging the close") on the expiration date for three contracts, the Commission's analysis focuses on the impact of its large positions outside the spot month: indeed, the Commission fails altogether to mention Amaranth's manipulative trading on expiration dates.
9. It is not really correct to call this the "Commission's analysis," because it is basically taken verbatim from a report on the Amaranth episode produced by the Senate Permanent Subcommittee on Investigations in 2007. This report is not adequate to support the Commission's necessity finding because it lacks any rigorous empirical analysis whatsoever. It repeatedly asserts, in a conclusory fashion, that Amaranth's large positions distorted prices. This analysis would not be accepted as evidence of causation in any peer reviewed academic work. Nor, in my opinion, would it be accepted as evidence in litigation.
10. The lack of real evidence that speculators not engaged in corners or other manipulative conduct like banging the close have caused "sudden and unreasonable or unwarranted fluctuations" in commodity prices means that the Commission's Necessity Finding fails utterly in its purpose as applied to any and all month limits. It has two examples, one of which relates to spot month limits, at best, and the other of which lacks evidence that the large speculator in question actually caused sudden or unreasonable fluctuations or unwarranted changes in price through its holdings of positions outside the spot month.
11. The Commission evidently understands this, because its Necessity Finding includes assertions of necessity not supported by the evidence of the cases it presents. For

instance, it states that corners and squeezes can lead to inefficient allocations of resources, but then makes a totally unsupported logical leap: "Similarly, prices that are influenced by the size of a very large speculative position, or trading that increases or reduces the size of this very large speculative position, may lead to inefficient allocations of resources to the extent that such prices do not allocate resources to highest and best use" (75689). This assertion is made in the context of the Hunts, which the CFTC recognizes was a corner. Although the assertion is true—and arguably tautological—as a matter of logic, the Commission provides no evidence that this theoretical possibility is a practical reality. Certainly neither the Hunt nor the Amaranth cases provide any such evidence. Moreover, there is little theoretical or empirical basis for this assertion in the academic literature.

12. Further, the Commission states: "Position limits are vital tools to prevent the accumulation of speculative positions that enable manipulation. But these examples also show that limits are necessary to achieve a broader statutory purpose: to prevent price distortions that can potentially occur due to excessively large speculative positions even in the absence of manipulation" (75963). The examples show no such thing.
13. The Commission goes on to say that it "has long found and again finds, based on its experience, that unchecked positions can potentially disrupt markets" (75963). If this long experience indeed provides evidence that would support such a finding, the Commission should be able to produce it and include it in its Necessity Finding. It does not do so. Thus, its claim is conclusory and unsupported by any evidence whatsoever.
14. This discussion focuses on the necessity of the position limit rule, generally. But the necessity requirement reasonably requires the Commission to show that the specific provisions of the rule are necessary to achieve the objective of reducing sudden and unreasonable or unwarranted fluctuations in prices. This analysis could be applied to virtually every aspect of the rule, but I will consider just two.
15. First consider the size of the limits. The rule limits a speculator's position to between 10 percent and 2.5 percent of open interest, in the any and all months, depending on the size of the market. In the two examples, the traders in question held positions far in excess of these limits. Thus, even if one agrees with the conclusions the Commission draws from these episodes (which I do not), they cannot show that the limits that the Commission has chosen are necessary to achieve the purpose of the statute that authorizes the Commission to impose limits as necessary.
16. Next consider the fact that the limits apply to all types of traders, even though different types of traders may pose different threats to cause sudden and unreasonable or unwarranted price changes, even under the theories and evidence the Commission advances in its necessity analysis. In the two examples relied upon, the traders that allegedly distorted prices were leveraged entities with a single decision maker. It is plausible that a single, leveraged trader is more likely to suffer losses that require a rapid liquidation of its positions that could cause prices to change (temporarily), and perhaps limits on such traders could reduce the frequency and severity of sudden price movements unrelated to fundamentals. But the rule applies to other entities that are very different and do not pose the same risks.
17. For instance, consider Exchange Traded Funds (ETFs). Many ETFs are not leveraged; the largest ones that would be most likely to be constrained by the limits are not. Moreover, although the funds themselves can be large, they mechanically buy or sell

futures contracts based on investments or withdrawals of funds by large numbers of individual investors acting independently. The trading of even levered ETFs is determined by the decisions of large numbers of independent actors and thus does not pose any greater risk than would exist if these same traders levered themselves and bought and sold directly rather than *via* the ETF. ETFs are really a mechanism that pools the trades of a relatively large number of small or modest-sized individual traders. Thus, most ETFs do not result in the combination of high leverage and lack of independent decision-making that is the basis for the Commission's necessity finding. The Commission has therefore failed to show that it is necessary to impose limits on these entities.

18. Similar analyses hold for other types of market participants. For instance, "real money" investors (including, for instance, pension funds) who trade commodity futures and swaps (frequently as part of commodity indexing strategies) are very different than the Hunts or Amaranth, both of whom were highly leveraged and whose derivatives positions were concentrated in a single commodity. Real money investors are typically not leveraged, and have only a small portion of their assets under management in any particular commodity. Therefore, whereas adverse movements in silver prices put the Hunts in financial distress, and adverse movements in natural gas prices threatened to bankrupt Amaranth, thereby causing these entities to have to unload positions quickly, price movements in any individual commodity market are unlikely to cause even a large real money investor to liquidate positions in a way that causes sudden price fluctuations. But the position limit rule limits these traders, even though they do not pose the same risk to the market as the type of traders the Commission invokes to justify the necessity of the limits.
19. Moreover, the "studies" that the Commission cites that purportedly support position limits are not reliable and have been consistently rebutted by subsequent work, including my own. The Commission's reliance on the 2009 Baker Institute report, which I publicly described at the time of its release as "a joke," is particularly perplexing.
20. Thus, the Commission has failed utterly to show that the "one size fits all" expansive breadth of the limits is necessary to reduce sudden and unwarranted price fluctuations. Indeed, the Commission has not even tried, or even given any indication that it is aware of the issue at all.

The Commission's Cost-Benefit Analysis is Severely Inadequate

21. The Commission's cost-benefit analysis is severely inadequate. With respect to benefits, a proper analysis would attempt to quantify (a) the effect of the proposed limits on the likelihood and frequency of sudden or unreasonable fluctuations or unwarranted changes in price in each of the markets subject to the rule, and (b) the costs of such price distortions. With respect to costs, a proper analysis would estimate the impact of the limits on risk bearing capacity in each of the covered markets, the impact of any reductions in this risk bearing capacity on the cost of hedging, and the effect of hedging cost increases on commodity producers and consumers. In this regard, it must be noted that contrary to the Commission's attempt to distinguish between hedging and speculation, these are inextricably linked, and speculators are needed to "preserve the integrity of derivative markets for the benefit of producers that use them to hedge risk and consumers that consume the underlying commodities" (75759). This is true because

hedgers need to transfer risks to speculators: constraining speculation constrains hedging.

22. The Commission does not carry out these analyses.
23. With respect to benefits, the Commission has identified two episodes during the last 35 years which it claims position limits would have prevented. As noted above, one of these episodes could have been prevented without any or all month limits. Even if one accepts the Commission's claim that the other episode distorted prices, at best the evidence that the Commission presents suggests that any and all month limits would eliminate one such episode every four decades or so. The Commission invokes its "experience" to claim that speculative distortions occur routinely, but absent empirical evidence, this is inadequate to identify any benefits of any and all month limits.
24. With respect to costs, position limits will be in effect continuously, and thereby have the potential to constrain the ability of hedgers to transfer risk to speculators at any time. Some recent empirical evidence suggests that such constraints are costly. Specifically, recent work by Hamilton and Wu,[1] and Christoffersen, Jacobs, and Li,[2] shows that risk premia in crude oil futures declined substantially (to virtually zero) during the period of time (the mid-2000s) that "financialization" of commodity markets allegedly accelerated: concerns about financialization have been the primary motivation to constrain speculation through position limits. Lower risk premia make hedging cheaper. Cheaper hedging makes it economical to hold larger inventories: larger inventories help reduce the frequency and severity of large price increases, thereby benefiting consumers. Moreover, cheaper hedging can lead to output increases that reduce prices on average: for instance, cheaper hedging by oil and gas producers provides an incentive for them to increase production. To the extent that position limits constrain the ability of the most efficient speculators (who hold the largest positions and hence are most likely to be affected by the limits) to take on risk from hedgers, these benefits are foregone: these foregone hedging benefits are a cost of position limits. The Commission makes no effort to estimate these effects.
25. The Commission could provide valuable evidence about the trade-off between costs and benefits by documenting for each commodity that would be subject to the proposed limits (using historical data from a long time period) how often limits would have been binding had they been in effect, and how much large speculators would have had to reduce their positions to come into compliance with the limits. Further, the Commission could provide useful evidence on the benefits of position limits by determining how often sudden and unreasonable price changes occurred during periods the limits would have been binding. Every episode in which price limits would have been binding if they had been in effect in the past, but there were no sudden and unreasonable price changes, is an episode in which the limits would have zero benefits and positive costs. The Commission could have carried out this analysis, but has not.
26. A proper cost-benefit analysis should quantify the net benefits position limits would create relative to the existing regulator regime, and relative to adjustments in the existing regime. It should identify which categories of market participants benefit, the sources of

[1] James Hamilton and Jing Wu, Risk Premia in Crude Oil Futures Prices, NBER Working Paper (2013).

[2] Peter Christoffersen, Kris Jacobs, and Bingxin Li, Dynamic Jump Intensities and Risk Premiums in Crude Oil Futures and Options Markets, working paper (2013).

those benefits, and their magnitude. Similarly, it should identify which types of participants are likely to incur the costs associated with the limits, identify the sources of those costs, and quantify them. The analysis should provide the data and information necessary for replication. Moreover, it should make sure to address issues—notably potential costs—raised by commenters, including those who commented on the 2011 position limit NOPR.

The Commission Presents No Logical or Empirical Justification for Limits Outside the Spot Month

27. I have already noted that Necessity Finding and the cost-benefit analysis provide no basis for the imposition of position limits outside the spot month, but the potentially damaging effects of these limits on the ability of the markets to serve their essential risk transfer function compels me to point out the flimsiness of the Commission's justification for these limits. They provide one plausible scenario of how a large position outside the spot month could cause sudden and unwarranted price fluctuations: the sudden liquidation of a large position by a trader facing financial distress. But they provide no evidence that this problem occurs with sufficient frequency, or has sufficiently damaging effects, to warrant continuously imposed constraints on risk transfer, and their imposition on parties who are extremely unlikely to be forced to liquidate in such a disorderly fashion.
28. Beyond that, the Commission relies solely on assertions about its "experience", which it does not document in any detail.
29. If trading in futures outside the spot month other than that involving disorderly liquidation distorts prices, it must distort quantities (e.g., production, consumption, and/or inventory) as well. The Commission describes no mechanism as to how this can happen when speculators are not holding physical positions (as the Hunts did). Nor am I aware of any plausible, rigorous theory that describes a mechanism by which this could happen. Further, the Commission provides no evidence of distortions in quantities symptomatic of price distortions, even during periods (such as the summer of 2008 in the oil market) during which speculators have been blamed for distorting prices.
30. This further reinforces my conclusion that there is no logical and empirical basis for the Commission's imposition of speculative limits outside the spot month.

Bona Fide Hedging Exemptions Are Unnecessarily Narrow and the Commission's Logic In Limiting These Exemptions Is Fundamentally Flawed

31. Reversing its earlier position, the Commission has now decided that it will not include an exemption for hedges of unfilled storage capacity (75718). Market participants may hedge storage capacity by buying a futures contract, and selling a future on the same commodity with a more distant expiration date (a "calendar spread" trade). The Commission bases its decision on its belief that such transactions are not economically appropriate, primarily because of the variability in calendar spreads. But it is precisely this variability that gives rise to the need to hedge: a firm can lock in its margin on storage transactions by engaging in a calendar spread: it is passing strange that the Commission uses the existence of a risk as a justification to deny an exemption to hedge.

32. Moreover, precisely because of the variability in the returns to storage space, a storage asset is like an option: the profitability of filling storage depends on calendar spreads. Sophisticated market participants can (and do) monetize this option, thereby locking in its value, by engaging in dynamic calendar spread transactions.[3] That is, due to the variability that the Commission mentions, a storage asset must be hedged dynamically, and this can be a very effective hedge of the asset. But the Commission's decision denies an exemption for the hedging of storage assets, based on a justification that fails to take into account the very implications of the basis for this denial.
33. Denial of an exemption for hedging of storage is also inconsistent with the permissibility of other hedges. Specifically, the Proposed Rule does permit hedges of processing margins: indeed, it permits cross hedges of processing margins (75722). Like returns to storage, the returns to processing are also variable, and based on the justification for denying hedge treatment for unfilled storage, this variability should preclude processing margin hedges as well: alternatively, the acceptance of processing margin hedges should lead to acceptance of storage hedges. It is difficult to understand the Commission's different treatment of these very analogous situations. Both involve hedges of assets whose profitability is driven by the difference between futures prices, where this differential is variable. Storage and processing are both transformations of commodities, the first in time, the second in form: why should the Commission permit the hedging of one transformation and not the other?
34. The Commission's cross hedging rules are also fundamentally flawed. The Commission proposes a quantitative standard, in which the correlation between the *spot commodity price* and the futures price of a future on another commodity, based on a data set of at least 36 months long, must exceed .8: hedges that do not this correlation standard will not receive a safe harbor for cross hedging (75717). As a specific example, the Proposed Rule presents estimates of the correlations between changes in the spot prices of electricity in several markets and changes in the nearby NYMEX natural gas price, finds that these correlation are well below .8, and concludes that natural gas futures would not be permitted as a cross hedge of electricity prices (75717-75718).
35. This fundamentally misunderstands how many cross hedges work, and the economics of commodity prices. Hedgers are often hedging forward prices/exposures not spot prices. In the case of electricity, for instance, in January, 2014 a generator may be hedging the price of power for delivery in July, 2014. If so, the firm is likely to use the July gas futures contract as a hedge. What's more, the correlation between the July gas futures price and the July power forward price will be different than, and likely far higher than, the correlation between the spot power price and the nearby gas futures price. The factors that cause low correlations between spot price and nearby futures price are very short term in nature: for instance, fluctuations in temperature or forced generation outages in January can affect the spot price dramatically, but have virtually zero impact

[3] A dynamic hedge is one where the size of the hedge position changes over time, in response to changes the market prices, and perhaps the passage of time. In the case of a storage asset, if spreads are wide and it is highly likely the capacity will be filled, the risk minimizing hedge is almost equal to the asset's capacity. If spreads are narrow (or the market is backwardated), it is less likely that the asset will be filled, and the size of the appropriate hedge position is a fraction, and perhaps a small fraction, of capacity.

on the July power forward price.[4] The main driver of the forward power price is typically the forward fuel price, which is natural gas in many markets. This issue of correlations varying with the tenor of the exposure is particularly pronounced in electricity, but can exist for other commodities as well.

36. Thus, the Commission's statistical test based on spot prices is completely inappropriate for evaluating many of the kinds of cross hedges market participants are likely to utilize. An appropriate test would examine the correlation between the prices of futures contracts that expire approximately contemporaneously with the exposure being hedged. The spot price is hardly ever the relevant measure of the exposure, and indeed, the Commission's denial of a safe harbor in the five-day period prior to expiration of a delivery-settled future means that it would be impossible to hedge a spot price using such a future anyways.
37. The Commission's setting of an 80 percent correlation level and requiring use of 36 months of data are also problematic. A 60 percent correlation, for example, would still permit a substantial reduction in risk, and, crucially, may be the best available hedge when both hedging effectiveness (measured by correlation) and liquidity are taken into consideration. Since market conditions can change, and since correlations are inherently dynamic, a 36 month estimation window can also be extremely inappropriate.[5] An analysis based on a shorter time series of data drawn from a period with similar conditions to those currently prevailing is a better measure of hedging effectiveness than a longer time series that may include data produced when market conditions were very different.

The Spot-Month Limits Are Arbitrary

38. The Commission proposes to set the "spot month" limit for a contract at 25 percent of deliverable supply, as estimated by the Designated Contract Market that lists the contract. The Commission proposes to update this limit every two years.
39. The limit the Commission promulgates is arbitrary, and not based on sound economics. This is true for at least two reasons.
40. First, a single long trader must have a position in excess of deliverable supply to execute a corner.[6] Thus, a 25 percent limit is unnecessarily low to prevent manipulation by a single trader.
41. Second, although imperfect competition between holders of long positions during the spot month could result in manipulative price distortions, this is highly unlikely to be a

[4] Chapter 8 of Craig Pirrong, Commodity Price Dynamics: A Structural Approach (2011) examines this issue in detail. In technical terms, the kinds of shocks that the factors that cause low correlations between spot fuel and power prices (weather/load shocks, outages) are highly "mean reverting", meaning that a shock today damps out rapidly, and thus has little impact on prices even a few days into the future.

[5] See Chapter 4 of Pirrong, supra note 4, for a discussion of how correlations can vary with market conditions. Chapter 8 discusses how gas price-power price correlations can also depend on market conditions.

[6] Stephen Craig Pirrong, The Economics, Law, and Public Policy of Market Power Manipulation (1996).

realistic possibility, meaning that the low limit offers little if any benefit. Five or more perfectly colluding traders each with positions at the 25 percent level might be able to manipulate the market, but such collusion is difficult to achieve. Moreover, the Commission has not demonstrated that this many traders are likely to hold the maximum position in the spot month. An even larger number of traders with positions at the limit would be necessary to distort prices if these traders are not perfectly competitive, but not perfectly collusive.

42. Third, the spot month limit applies to longs and shorts. Economic theory demonstrates that a market that is susceptible to corners (manipulations by large longs) is not susceptible to manipulation by large shorts. For storable commodities like those covered by the position limit proposal, manipulations by long traders (corners or squeezes) are more likely than manipulations by shorts.[7] Therefore, the 25 percent limit, which is already overly restrictive for long traders, is especially so for shorts. Applying the same limit to longs and shorts is arbitrary, and inconsistent with an understanding of the economics of manipulation in commodity markets.
43. The foregoing analysis is based on the assumption that deliverable supply is measured accurately. However, since deliverable supplies can vary substantially over even short periods of time, the two year updating cycle for the spot limit means that the limit will almost diverge from 25 percent of the actual deliverable supply. When deliverable supplies are larger than the level used to calculate the limit, the already unnecessarily small 25 percent of deliverable supply spot limit will be especially constraining, and especially unnecessary to prevent corners or squeezes. If the current deliverable supply is substantially (more than 75 percent) below the level used to determine the spot limit, it is possible that the limit will be inadequate to prevent a corner or squeeze. However, since the 25 percent limit is likely to be unduly restrictive on average, there is a pronounced asymmetry. The limit is almost certain to be smaller than necessary to prevent manipulation far more frequently than it is too big to prevent corners or squeezes.

The Spot-Month Limits on Delivery-Settled and Cash-Settled Contracts Are Logically Inconsistent

44. There are other problematic aspects to the spot-month limits as well.
45. Specifically, the limit proposal contains certain logical inconsistencies that undermine their utility and efficiency as a means of preventing manipulation.
46. The proposal assigns different limits to delivery-settled and cash-settled contracts. For delivery-settled contracts, the limit is one-quarter of the estimated deliverable supply. As written, the proposal does not impose any limit on the ownership of deliverable supply. For cash-settled contracts, the limit is five times the spot-month position limit, i.e., 25 percent more than deliverable supply. Moreover, the limit permits the holder of the cash-settled futures to own up to one-quarter of the deliverable supply. Thus, the combined deliverable supply-cash settled position can reach 150 percent of deliverable supply.

[7] Id.

47. The delivery-settled limit implicitly assumes that ownership of less than one-fourth of the deliverable supply is sufficient to distort prices.[8] If this is true, the holder of cash-settled futures could buy up one-fourth of deliverable supply, hold it off the market to inflate prices, and profit on his cash-settled derivatives as a result of the price inflation. But this would allow the owner of the cash-settled position to earn more than five times the profit as the holder of a delivery-settled contract because the position limit on the former is five times the limit on the latter. These limits are certainly inconsistent with one another based on an understanding of the economics of manipulation.
48. Therefore, if the Commission intends to impose limits in the spot month, it should first review and present data supporting the levels it intends to impose (and it should make that data publically available so that it may be independently evaluated). In addition, if the Commission intends to set different levels for cash-settled and physically-settled contracts, it should present data that justifies the different levels, including an analysis of the relationship between the amount of the physical commodity held by a market participant and the limits the Commission would impose, and an analysis of the probability of market participants acting in collusion (either perfectly or imperfectly).

Summary and Conclusions

49. The Commission's re-proposed position limit rule is highly objectionable, and will undermine, rather than advance, the fundamental purposes of derivatives markets: risk transfer and price discovery. The Commission's Necessity Finding does not in fact show that position limits outside the spot month are necessary to prevent or diminish sudden and unreasonable or unwarranted price fluctuations. Furthermore, the Commission's cost-benefit analysis is perfunctory and incomplete, and fails to identify, let alone analyze, important potential costs. The bona fide hedging exemptions from the limits unnecessarily and inefficiently restrict hedging, and the analysis supporting these restrictions is at odds with basic economics. Further, the spot month limits are set arbitrarily. Finally, the different spot month limits for delivery-settled and cash-settled is inconsistent with an understanding of the economics of manipulation.
50. In my opinion, moving forward with such a flawed rule would not eliminate sudden and unwarranted price fluctuations, for the Commission has provided no evidence that such fluctuations do occur or are even a practical concern at present or in the future. Moreover, the rule would impose compliance burdens on market participants, and if the limits actually bind they will constrain efficient risk transfer. This would harm hedgers first and foremost and would actually be more likely to result in greater price volatility than less.

[8] "Less than one-fourth" because to profit, a manipulator takes deliveries (or buys up the deliverable commodity) to drive up prices, but must sell some futures at the inflated price. If taking ownership of at least one-fourth of deliverable supply is necessary to distort prices, the holder of a futures position equal to one-fourth of deliverable supply could not manipulate profitably (unless he owned deliverable supplies not acquired via delivery). If, in fact, taking delivery of more than 25 percent of deliverable supply is necessary to distort prices, the limit is too small.

51. In sum, the proposal is fundamentally flawed, and the Commission would serve the public interest by withdrawing it.

Sincerely,

Craig Pirrong

Craig Pirrong