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March 25, 2011

Via Electronic Submission

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

Re: Position Limits for Derivatives (RIN 3038-AD15 and 3038-AD16)

Dear Mr. Stawick:

The Futures Industry Association, Inc. ("FIA") appreciates the opportunity to provide the Commodity Futures Trading Commission ("Commission") with the comments and recommendations set forth below in response to the Commission's Notice of Proposed Rulemaking concerning Position Limits for Derivatives, 76 Fed. Reg. 4752 (January 26, 2011).[1] FIA's comments and recommendations focus on the statutory and public policy issues that should inform the Commission's determination about whether it is necessary to impose position limits, and if so, what limits are appropriate.

I. Interest of FIA in the Commission's Proposed Position Limits

FIA's members, their affiliates and their customers actively participate in the listed and over-the-counter ("OTC") derivatives markets as intermediaries, principals and users.[2] For this reason, FIA participated in the legislative process that led to the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"). Moreover, as the Commission and other federal agencies work to implement the Dodd-Frank Act, FIA has publicly committed to assist them by providing the information, comments, and

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[1] FIA refers to the Supplementary Information in the Commission's Notice of Proposed Rulemaking as the "NOPR" and to the text of the proposed position limit rule as the "Proposed Rule."

[2] FIA's regular membership is comprised of approximately 30 of the largest futures commission merchants ("FCMs") in the United States, the majority of which also are either registered with the Securities and Exchange Commission ("SEC") as broker-dealers or are affiliates of broker-dealers. Among its associate members are representatives from virtually all other segments of the futures industry, both national and international. Reflecting the scope and diversity of its membership, FIA estimates that its members effect more than 80 percent of all customer transactions executed on U.S. designated contract markets.

recommendations they need to ensure that the U.S. derivatives markets remain the most efficient and competitive in the world.[3]

Section 737 of the Dodd-Frank Act amended the Commission's authority in Section 4a of the Commodity Exchange Act ("CEA") to establish position limits by, for the first time, extending that authority to cleared and uncleared swaps. Unlike most other provisions in the legislation, amended Section 4a became effective on July 21, 2010.[4] It authorizes the Commission in specified circumstances to set limits on the size of positions, other than *bona fide* hedging positions, in futures, options on futures, and swap contracts involving exempt and agricultural commodities that may be held by any person. As active participants in, and users of, the U.S. derivatives markets, FIA and its members have a significant interest in the Commission's proposed federal speculative position limits and its proposed definition of *bona fide* hedging transactions.

II. Preliminary Statement

FIA appreciates the Commission's consideration of the pre-rule proposal comments submitted by FIA and other market participants, and the Commission's adoption, at least in part, of some of those recommendations. In particular, although FIA believes that the current record does not establish that position limits are necessary, FIA commends the Commission for proposing a two-phased approach to the imposition of position limits, *i.e.*, spot month limits based on 28 core referenced contracts in the initial phase, and the imposition of additional limits in the second phase after the Commission collects position data on physical commodity swaps. FIA also supports the Commission's decision to eliminate its January 2010 proposal to "crowd out" a trader's ability to take speculative positions once a trader relies on a hedge exemption. Finally, FIA appreciates the Commission's proposal to provide a methodology, at least for non-financial entities, for requesting an exemption from the requirement to aggregate positions in commonly-owned accounts.

FIA respectfully submits that the Proposed Rule is a "solution" to a non-existent problem. As we explain in further detail below, the Proposed Rule does not satisfy the statutory prerequisites for establishing position limits. The Commission does not cite, and FIA is not aware of, any factual basis for concluding that position limits are "necessary to diminish, eliminate or prevent" the burden on interstate commerce caused by excessive speculation, or that the levels proposed by the Commission are "appropriate." Like all market participants, FIA is well-aware of claims by some that speculative investments have contributed to an increase in commodity prices. However, there is no objective evidence that these claims are true. In fact,

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[3] On October 1, 2010, FIA provided the Commission with comments that made several substantive and process recommendations about whether, and if so how, the Commission should consider exercising its authority under Section 4a of the Commodity Exchange Act, as amended. Previously, on March 18, 2010, FIA submitted extensive comments and recommendations in response to the Commission's January 26, 2010 proposal to set Federal Speculative Position Limits for Referenced Energy Contracts.

[4] Because the amendments to Section 4a are effective, FIA generally refers to the CEA sections rather than Section 737 of the Dodd-Frank Act when discussing the Commission's position limit authority.

all 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 increased market liquidity and, if anything, had a moderating influence on commodity prices.[5]

We are also concerned about the public policy considerations of imposing significant new restrictions on the ability of market participants to trade listed and OTC derivatives without adequate factual support for those restrictions. The price discovery and risk-shifting functions of the U.S. derivatives markets are too important to U.S. and international commerce to be the subject of a position limit experiment based upon unsupported claims about price volatility caused by speculative positions. FIA respectfully submits that the Commission will not be able to assure Congress and market participants that any limits it proposes will not adversely affect the liquidity and price discovery function of those markets until after it collects and analyzes information about the positions of market participants in the contracts for which the Commission proposes to set limits.

The Commission and the Chairman have stated on a number of occasions that the Commission's mandate is to ensure fair, orderly and competitive markets, not to set prices.[6] Competitive commodity derivatives markets are designed to generate prices that reflect supply and demand fundamentals. Those market fundamentals sometimes cause prices to increase, and at other times cause them to decrease. It is important to market participants that the Commission take care to ensure that its proposed position limit regulations will promote price discovery that reflects supply and demand, even if it means that, when demand exceeds supply, prices will increase to attract additional supply. The Commission's regulations also should enable hedgers to shift risks to speculators who are willing to assume those risks in highly liquid derivatives markets. After all, in Section 3(a) of the CEA, Congress declared that "[t]he transactions subject to this Act . . . are affected with a national public interest by providing a means for managing and *assuming price risks . . . .*"[7]

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[5] *See* the studies discussed in note 14, below.

[6] *See* Testimony of CFTC Chairman Gary Gensler before the U.S. House Committee on Appropriations, Subcommittee on Agriculture, March 17, 2011 ("[T]he CFTC is not a price-setting agency. . . "); Testimony of CFTC Chairman Gary Gensler before the U.S. Senate Committee on Agriculture, Nutrition & Forestry, March 3, 2011; 76 Fed. Reg. at 4777 ("The CFTC does not set or regulate prices. Rather, the Commission is directed to ensure that commodity markets are fair and orderly to protect the American Public"); The CFTC mission statement available at http://www.cftc.gov/About/MissionResponsibilities/index.htm ("[T]he CFTC assures the economic utility of the futures markets by encouraging their competitiveness and efficiency . . . . Through effective oversight, the CFTC enables the futures markets to serve the important function of providing a means for price discovery and offsetting price risk."); CFTC Budget and Performance Estimate for FY 2012 available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/cftcbudget2012.pdf ("Since the passage of the CEA, the CFTC and its predecessor agencies have been responsible for ensuring the fair, open and efficient functioning of futures markets.").

[7] *See* CEA § 3(a) (emphasis added).

In addition to the lack of a sufficient legal and factual predicate for the Proposed Rule, the text of the Proposed Rule creates, either intentionally or unintentionally, a position limit, hedge exemption and position aggregation regime that is commercially unworkable and inconsistent with long-standing risk management practices in the U.S. derivatives markets. For all of these reasons, the Commission should withdraw the Proposed Rule.

III. Summary of FIA's Comments and Recommendations

For the convenience of the Commission and its staff, set forth below is a summary of FIA's comments on, and specific recommendations for, revising the Proposed Rule:

- The Commission should either withdraw the Proposed Rule, or defer consideration of position limits until after it has collected and analyzed the data necessary to make the statutorily required finding that (1) such limits are "necessary" to "diminish, eliminate or prevent" the burden on interstate commerce caused by excessive speculation, and (2) the limit levels proposed by the Commission are "appropriate."
- Spot month position limits for Referenced Contracts should not be based solely on 25 percent of "the quantity of the commodity meeting a derivative contract's delivery specifications." Rather, the Commission should take into account "the individual characteristics" of each core referenced contract, including the different settlement options — such as EFPs — available for each contract, in setting spot month position limits.
- The Commission should set position accountability levels, rather than hard limits, on single month and all-months-combined positions in Referenced Contracts, and should not adopt its position visibility proposal.
- The Commission should (1) define *bona fide* hedging transactions and positions more broadly so that they encompass long-standing and important commercial risk management practices, (2) re-institute a process by which hedgers can seek exemptions for non-enumerated hedging transactions, and (3) exercise its exemptive authority to implement a process by which liquidity providers can obtain hedge exemptions from speculative position limits.
- The procedures and reporting requirements applicable to *bona fide* hedgers should be modified so that they (1) are commercially practicable, and (2) provide the Commission with useful information that it will be able to review and analyze with the resources available to it.
- The proposed restriction on the Conditional Limit for cash-settled Referenced Contracts should be eliminated because it is not necessary to prevent excessive speculation and manipulation.

- The Commission's long-standing independent account controller exemption from mandatory aggregation of positions in commonly held accounts should be re-instituted by permitting an independent account controller to apply for an exemption that is conditionally effective when filed.
- Financial entities that (1) exercise and maintain independent control over trading and positions, and (2) satisfy reasonable criteria for an exemption from the requirement to aggregate commonly held accounts, should be permitted to apply for an exemption that is conditionally effective when filed.

IV. The Commission's Proposed Position Limits

A. The Commission Proposes a Two-Phase Implementation Schedule

In the Proposed Rule, the Commission proposes to impose spot month, single month, and all-months-combined limits on:

- 28 core referenced futures contracts in agricultural and exempt commodities on a Designated Contract Market ("DCM"); **and**
- any futures, option, or swap contract that:
  - is directly price-linked to a core referenced contract; **or**
  - settles to a price series that prices the commodity at:
    - the same delivery location as a core referenced contract; **or**
    - another delivery location with substantially the same supply and demand fundamentals as the delivery location of a core referenced contract (collectively the "Referenced Contracts").[8]

The Commission proposes to implement the position limits in two phases:

- Phase 1 will impose spot month speculative position limits aggregately on the Referenced Contracts based on current exchange-set limits applicable to the spot month as defined by the exchanges; and

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[8] Under CEA § 4a, the CFTC is authorized, in accordance with the standards set forth in CEA § 4a(a)(1), to set "by rule, regulation, or order" position limits on the following contracts:

- futures contracts traded on a DCM or a derivatives transaction execution facility (CEA § 4a(a)(1));
- swaps traded on a DCM or a swap execution facility ("SEF") (CEA §4a(a)(1)); and
- swaps not traded on a DCM or SEF that perform or affect a significant price discovery function with respect to registered entities (CEA § 4a(a)(1)).

In addition, CEA § 4a(a)(5) authorizes the Commission to establish limits on swaps that are economically equivalent to futures contracts and options on futures contracts traded on a DCM (CEA § 4a(a)(5)).

- Phase 2 will impose Commission-set spot month, single month, and all-months-combined position limits on the Referenced Contracts.[9]

In both phases, spot month limits will apply separately to physical-delivery and cash-settled Referenced Contracts, with the exception of those Referenced Contracts at a delivery location other than the applicable core referenced futures contract. For non-spot month positions, the Commission's proposed limits would apply separately to two classes of contracts: (1) all futures and options executed on a DCM; and (2) all swaps.

V. The Commission Should Not Impose Position Limits on Referenced Contracts Without First Finding That They Are "Necessary" and That Its Proposed Levels Are "Appropriate"

As FIA pointed out in its October 1, 2010 pre-rulemaking comments, Section 4a(a)(2) expressly provides that, before the Commission can establish limits "as appropriate" on speculative positions in Referenced Contracts, it must make separate findings pursuant to Section 4a(a)(1) for each type of Referenced Contract that position limits are "necessary to diminish, eliminate or prevent" the burden on interstate commerce caused by excessive speculation – commodity price fluctuations that are sudden, unreasonable or unwarranted.[10] Many other commenters have made the same point.[11]

In the NOPR, the Commission stated that it is not required to find that:

- an undue burden on interstate commerce caused by excessive speculation exists or is likely to occur; or
- position limits are necessary to prevent sudden or unreasonable fluctuations or unwarranted changes in prices.

The Commission also asserted that it can "impose position limits prophylactically, based on its reasonable judgment that such limits are necessary" to diminish, eliminate, or prevent the "burdens on interstate commerce that the Congress has found result from excessive speculation."[12]

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[9] The Commission noted in the Proposed Rule that it will propose position limits for swaps that perform a significant price discovery function with respect to regulated entities in a separate rulemaking process.

[10] Futures Industry Association, Pre-Rulemaking Position Limit Comments and Recommendations at p.4 (Oct. 1, 2010).

[11] *See*, *e.g.*, Pre-Rulemaking Position Limit Comments of Asset Management Group of the Securities Industry and Financial Markets Association at pp. 3-4 (Nov. 23, 2010); Pre-Rulemaking Comments of International Swaps and Derivatives Association & Securities Industry and Financial Markets Association, Proposed Regulations Regarding Position Limits for Derivatives at p.5 (Jan. 11, 2011); Pre-Rulemaking Comments of Electric Power Supply Association, Implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act – Position Limits at p.2 (Aug. 23, 2010).

[12] 76 Fed. Reg. at 4754.

The Commission's statements about its authority to impose position limits are not consistent with the plain language of Section 4a(a)(1). While Congress may have made a finding that sudden and unreasonable price fluctuations are an undue burden on interstate commerce, the statute could not be clearer about the Commission's obligation with respect to position limits: "[T]he *Commission* shall . . . fix such limits . . . *as the Commission finds* are necessary to diminish, eliminate, or prevent such burden."[13] Nowhere does Section 4a(a)(1) say or suggest that the Commission can fix position limits "prophylactically, based on its reasonable judgment that such limits are necessary." To the contrary, Section 4a(a)(1) requires the Commission to make a finding for each Referenced Contract that position limits are necessary.

The Commission does not cite any factual basis in the NOPR for its "reasonable judgment," much less a finding, that position limits are "necessary" to "diminish, eliminate or prevent" the burden on interstate commerce caused by excessive speculation, or that the limit levels proposed by the Commission are "appropriate."[14] Indeed, the Commission acknowledges that it lacks the data to make the required finding because it does not expect "the collection of positional data to begin [until] the third quarter of 2011."[15] As FIA and others have stressed in their prior comments, the Commission should collect and examine data concerning positions

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[13] CEA § 4a(a)(1) (emphasis added).

[14] There is no objective evidence that speculative investments have contributed to an increase in commodity prices. In fact, all 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 increased market liquidity and, if anything, had a moderating influence on commodity prices. *See* International Energy Agency – Oil Market Report at pp. 44-45 (Mar. 15, 2011) (Price volatility is attributable to market fundamental factors and not to positions of passive investors in exchange-traded futures markets.); The Impact of Index and Swap Funds on Commodity Futures Markets: Preliminary Results, OECD Food, Agriculture and Fisheries Working Papers, No. 27 at p.1 (2010) ("The empirical evidence . . . does not appear at present to warrant extensive changes in the regulation of index funds participation in agricultural commodity markets . . . [L]imiting the participation of index fund investors could unintentionally deprive commodity futures markets of an important source of liquidity and risk-absorption capacity . . . ."); Commodity Regulation: Uncertainty Rules at Figure 3, Barclays Capital Commodities Research (Feb. 24, 2011) ("For most commodities, index buying is not associated with rising prices"); Opening Statement of Commissioner Michael Dunn at CFTC Public Meeting on Proposed Rules Under Dodd-Frank Act, January 13, 2011 ("To date, CFTC staff has been unable to find any reliable economic analysis to support either the contention that excessive speculation is affecting the markets . . . or that position limits will prevent excessive speculation. The task then is for the CFTC staff to determine whether position limits are appropriate. With such a lack of concrete economic evidence, my fear is that, at best, position limits are a cure for a disease that does not exist or at worst, a placebo for one that does."); Interim Report on Crude Oil, Interagency Task Force on Commodity Markets at p.5 (July 2008) ("the activity of [speculators] has not resulted in systematic changes in price . . . the positions of hedge funds appear to have moved inversely with the preceding price changes, suggesting instead that their positions might have provided a buffer against volatility-inducing shocks."); Staff Report on Cotton Futures and Options Market Activity During the Week of March 3, 2008 (Jan. 4, 2010); the Report on Large Short Trader Activity in the Silver Futures Market (May 2008). In addition, CFTC economists writing independently have published articles analyzing the effect of speculation in the energy markets and found no link between price changes in natural gas and crude oil markets and changes in positions of managed money traders. *See*, *e.g.*, Price Dynamics, Price Discovery and Large Futures Trader Interactions in the Energy Complex (Apr. 28, 2005); Fundamentals, Trader Activity and Derivatives Pricing (Dec. 4, 2008).

[15] 76 Fed. Reg. at 4756.

held by market participants in Referenced Contracts before deciding whether to propose limits on those positions.

There are two fundamental problems with any effort by the Commission to impose position limits without first collecting and analyzing the facts needed to determine whether position limits are necessary, and whether the levels set by the Commission are appropriate. First, the Commission's final regulation may be legally infirm and, therefore, subject to judicial challenge.[16] Second, and most important, without the necessary factual predicate, the Commission cannot assure Congress or market participants that the position limits it sets will not adversely affect the liquidity and price discovery function of the U.S. derivatives markets, or cause the price discovery function to shift to foreign boards of trade.[17] For these reasons, FIA urges the Commission to withdraw the Proposed Rule or, at a minimum, defer consideration of position limits until after it collects and analyzes the data necessary to make the statutorily required finding that such limits are necessary and appropriate.[18]

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[16] *See Amer. Med. Ass'n v. Reno*, 57 F.3d 1129, 1132 (D.C. Cir. 1995); *see also*, *Owner-Operator Indep. Drivers Ass'n v. Fed. Motor Carrier Safety Admin.*, 494 F.3d 188 (D.C. Cir. 2007) (no meaningful opportunity for public comment where agency's notice of proposed rule revising long-haul truck drivers' hours failed to disclose methodology behind operator-fatigue model that was central to agency's decision to adopt proposed rule; agency's disclosure of methodology when it published final rule was "too late for interested parties to comment"); *Chamber of Commerce v. SEC*, 443 F.3d 890 (D.C. Cir. 2006) (no meaningful opportunity for public comment where agency extensively relied on extra-record materials in arriving at cost estimates for proposed rule that adjusted qualification standards for mutual funds to get exemptions under Investment Company Act); *Engine Mfrs. Ass'n v. EPA*, 20 F.3d 1177 (D.C. Cir. 1994) (no meaningful opportunity for public comment where agency's notice of proposed rule to assess engine manufacturers full cost for EPA's Motor Vehicle and Engine Compliance Program did not present intelligible data to support agency's assumptions and therefore failed to adequately explain the basis upon which agency computed fees).

[17] In connection with proposing limits, Congress directed the Commission to consider (1) whether position limits may cause price discovery to shift to foreign boards of trade ("FBOT"), and (2) the effect that position limits may have on market liquidity and the price discovery function of the underlying markets. *See* Sections 4a(a)(2)(C) and (3).

[18] In a March 16, 2011 speech, Commissioner Chilton referenced a number of reports that attribute 2008 increases in crude oil and agriculture prices to speculative positions. Speech available at http://www.cftc.gov/PressRoom/SpeechesTestimony/opachilton-41.html. He also noted that speculative positions in energy markets have increased by 64 percent. However, a comparison of the notional value of index investment in heating oil, natural gas, gasoline, and crude oil markets in 2008 with the most recent 2011 data actually show a **decrease** of more than $8 billion. FIA also notes that the Special Call data do not show the amount of this investment that is in futures contracts and that open interest in these four futures markets has not increased significantly since 2008. In addition, the reports that Commissioner Chilton cited are inconsistent with the congressional testimony of the Commission's Staff Economists in 2008, who testified that market fundamental factors had caused commodity prices to increase. *See* Testimony of Jeffrey Harris, Chief Economist and John Fenton, Director of Market Surveillance Before the Subcommittee on General Farm Commodities and Risk Management, Committee on Agriculture, May 15, 2008 ("[T]here is little economic evidence to demonstrate that prices are being systematically driven by speculators in these markets. . . . It is critical to recognize that speculators provide valuable liquidity and information to the futures markets, and this helps reduce the costs of hedging and risk transfer for market participants."); *see also* Testimony of CFTC Chief Economist Jeffrey Harris Before the Senate Energy Subcommittee of the Committee on Energy and Natural Resources, September 16, 2008 ("[W]hile oil prices were rising dramatically during the first half of 2008, net speculative positions have been largely falling.").

VI. Comments on the Proposed Position Limits

A. The Commission Should Reconsider Its Proposal to Base Phase Two Spot Month Limits on "Deliverable Supply"

Historically, the Commission has set, and required exchanges to set, spot month position limits in physical-delivery futures contracts based on 25 percent of estimated deliverable supply. And in Phase Two, the Commission proposes to set spot month position limits based upon either the Commission's or the exchange's estimate of deliverable supply for each core referenced contract. The Commission defined deliverable supply in the Proposed Rule as:

> the quantity of the commodity meeting a derivative contract's delivery specifications that can reasonably be expected to be readily available to short traders and saleable by long traders at its market value in normal cash marketing channels at the derivative contract's delivery points during the specified delivery period, barring abnormal movement in interstate commerce.[19]

The Commission should not set a single spot month limit for the Referenced Contracts based solely on 25 percent of "the quantity of the commodity meeting a derivative contract's delivery specifications."[20] As the Commission pointed out in 1987, when it undertook a major review of its position limit regime, "[t]here are vast differences among the contracts for the same or similar commodities. Accordingly, it would appear inappropriate to set a single speculative position limit for all markets trading the same or similar commodities." FIA recommends, therefore, that the Commission take into account "the individual characteristics" of each core referenced contract in setting Phase Two spot month position limits.[21]

In the nearly 25 years since 1987, the derivatives and commodities markets have evolved in ways that make it even more inappropriate now to set a single spot month limit for all Referenced Contracts based upon the Commission's historical view of what constitutes deliverable supply. For example, on a month-to-month basis, few, if any, Light Sweet Crude Oil futures contracts go through the NYMEX delivery process at expiration. Rather, market participants who elect to settle their positions by making or taking delivery have developed a robust Exchange of Futures for Physical market. This mechanism allows the participants to negotiate for the grade and location of crude oil that meets the buyer's specific need and the seller's available supply. As a result, the futures contract is far less susceptible to a corner or

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[19] 76 Fed. Reg. at 4757.

[20] The Commission has taken a broader view of what constitutes deliverable supply in its administrative decisions. For example, the Commission explained that "available deliverable supply" is measured over the period in which a market participant can procure a commodity with "prudent planning," and includes: (1) all available local supply, (2) all deliverable non-local supply, and (3) all comparable supply (based on factors such as product and location). *In re Cox*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,786 at 34,062-65 (CFTC Jul. 15, 1987).

[21] *Revision of Federal Speculative Position Limits*, 52 Fed. Reg. 38914, 38917 (Oct. 20, 1987).

squeeze than it would be if the contract only could be physically settled by delivery of "available supply" at a pipeline or storage facility in Cushing, Oklahoma.

FIA recommends that the Commission consult with the exchanges and commercial market participants before it sets limits based on its historical definition and calculation of deliverable supply. The Commission needs a thorough understanding of the supply characteristics, and commercial settlement and delivery practices for each Referenced Contract before it can determine the most appropriate parameters to use when setting spot month position limits. If the Commission conducts the necessary diligence, it will be able to set spot month limits for the Referenced Contracts that are less restrictive than those based on its currently proposed definition of deliverable supply and still ensure that physical-delivery Referenced Contracts are not susceptible to manipulation.

B. The Commission Should Modify Its Proposed Spot Month Position Limits on Cash-Settled Contracts

The Commission proposed separate spot month limits for physical-delivery contracts and cash-settled contracts. The NOPR explains by example that if the spot month limit is 1,000 contracts, a market participant may hold a position of up to 1,000 physical-delivery contracts and 1,000 cash-settled contracts. However, the NOPR does not mention that, because positions in cash-settled futures and swaps that are price-linked to a core referenced contract will be aggregated for purposes of the spot month limit, the Proposed Rule will substantially reduce the cash-settled positions that a trader can hold. For example, the current ICE WTI crude oil futures contract spot month limit is 3,000 contracts and the current NYMEX WTI calendar swap futures contract spot month limit is also 3,000 contracts. Thus, a market participant currently can hold a position up to the speculative limit in **each** contract. In contrast, under the Proposed Rule, a market participant would be subject to an aggregate spot limit of 3,000 contracts for **both** positions. The proposed limit is more restrictive than necessary for cash-settled contracts, which are not measurably susceptible to manipulation, and will substantially reduce liquidity in important price discovery markets.

Furthermore, although the Proposed Rule allows a trader to hold (1) a speculative spot month position in a cash-settled Referenced Contract that is five times the spot month limit, and (2) a position in the underlying cash market commodity of up to 25 percent of deliverable supply, the higher limit is conditioned on the trader not holding a position in the physical-delivery Referenced Contract spot month. In the NOPR, the Commission cites the current Acceptable Practices for DCM Core Principle 5 to support the restrictions on the proposed conditional spot month limit for cash-settled contracts. However, the guidance provided by the Commission to DCMs in Appendix B to Part 38 states that "[in] general, *position limits are not necessary* for markets where the threat of excessive speculation or manipulation is nonexistent or

very low."[22] And, among the listed futures markets for which the Commission has not required a DCM to impose speculative limits are "contracts specifying cash settlement where the potential for distortion of such price is negligible."[23]

FIA recommends that the Commission follow its own guidance and eliminate the restriction on holding speculative positions in physical-delivery because it is not necessary to prevent excessive speculation or manipulation. If, by the Commission's own determination, holding a position in a physical-delivery contract within the spot month limit is not excessive speculation or likely to increase the risk of manipulation, then holding a position in the physical-delivery contract should not restrict a trader's ability to hold a spot month cash-settled contract position up to five times the limit.

C. Hard Position Limits on Any Single Month and All-Months-Combined Are Not Necessary to Prevent Excessive Speculation

In Phase Two, the Proposed Rule would impose hard limits on any single month or all-months-combined in the Referenced Contracts. As FIA recommended in its October 1, 2010 letter, the Commission should impose federal accountability levels rather than hard limits. In 1998, when the Commission codified an exemption that permitted exchanges to substitute position accountability rules for position limits, it noted that "precious metals and energy contracts are characterized by underlying cash markets with liquidity equivalent to or greater than certain of the financial futures and options which the Commission exempted [from speculative position limits]."[24] In addition, the Commission's guidance to DCMs in Appendix B to Section 38 of its regulations states with respect to Core Principle 5 that: "[m]arkets appropriate for position accountability rules include those with large open-interest, high daily trading volumes and liquid cash markets."[25] The NOPR does not explain why the Commission's prior guidance does not provide a basis today for an exemption from hard speculative position limits for these same markets.

For more than a decade, market participants have operated their businesses and conducted their trading activities in reliance upon the exchange position accountability framework. Before modifying that framework, the Commission and market participants would benefit from a detailed factual record showing whether accountability levels are sufficient to

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[22] 17 C.F.R. § 38, Appendix B (emphasis added). Note: In its December 22, 2010 proposed rules, Core Principles and Other Requirements for Designated Contract Markets, the Commission removed the Acceptable Practices and Guidance for Core Principle 5 and proposed a new Core Principle 5 that a DCM "adopt for each contract . . . as is necessary and appropriate, position limitations or position accountability for speculators." (*See* Core Principles and Other Requirements for DCMs, 75 Fed. Reg. 80572, 80629 (Dec. 22, 2010.)

[23] 17 C.F.R. § 38, Appendix B.

[24] *Revision of Federal Speculative Position Limits and Associated Rules*, 63 Fed. Reg. 38525, 38529 (Jul. 17, 1998).

[25] 17 C.F.R. § 38, Appendix B.

deter excessive speculation and the risk of manipulation.[26] If, despite the lack of a demonstrated need, the Commission nevertheless decides to impose hard limits instead of accountability levels, then FIA recommends that the Commission adopt its alternative proposal to calculate those limits for precious metals and energy Referenced Contracts using a formula of 10 percent of the first 25,000 contracts of open interest plus five percent of the remaining open interest contracts. A higher limit is appropriate for precious metals and energy Referenced Contracts because the underlying cash markets are highly liquid.

Finally, the Commission requested comments on whether the Commission should retain legacy position limits for enumerated agricultural commodities or adopt the levels recommended by the Chicago Board of Trade ("CBOT") in an April 6, 2010 petition.[27] FIA supports the CBOT's recommendation and believes that the Commission should maintain its historical approach of imposing the same limits on the Minneapolis Grain Exchange and Kansas City Board of Trade wheat contracts. For the same reasons discussed above, the ability of traders to use these markets to shift and assume risks should not be constrained absent a demonstrated need for lower limits.

D. The Commission's Open Interest Calculation Should Be Transparent So Market Participants Will Have Advance Notice of Likely Changes to Position Limits

Section 151.4(h) of the Proposed Rule provides that the Commission will fix position limits based on the formula applied to open interest by January 31st of each calendar year. As a result, market participants face uncertainty about potential annual changes to position limit levels. The Commission explained in the NOPR that "the open interest base levels would be calculated in the same manner described in the Commission's January 2010 release proposing position limits."[28] However, as FIA noted in its March 18, 2010 comments, many market participants were unable to replicate the Commission's open interest calculation. Accordingly, FIA requests that the Commission make the open interest figures, and any other data that it will use to re-calculate the limits available to market participants as soon as practicably possible and, at a minimum, well in advance of issuing any new limits. The Commission's calculation process should be public to give market participants sufficient time to anticipate changes to, and adjust their positions to comply with, the applicable limits. The Commission also should consider basing the limits on a rolling average of the open interest calculation to ensure that any adjustments to limits are gradual and reflect long-term market trends.

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[26] Another advantage of accountability levels is that they provide FCMs, swap dealers and market participants with the flexibility to assist exchanges in maintaining orderly markets when it is necessary to transfer a portfolio of Referenced Contracts from a distressed market participant. Otherwise, the party acquiring the portfolio may not have the position limit capacity necessary to incorporate those transactions within its existing portfolio of Referenced Contracts, and manage the risks associated with the transferred positions without violating hard position limits.

[27] 76 Fed. Reg. at 4760.

[28] *Id*. at 4759-60.

E. The Proposed Position Visibility Regulations Are Unnecessary

The Proposed Rule, in Section 151.6, includes a requirement that market participants who hold positions that reach specified levels in certain metals and energy contracts report those positions along with other proprietary information to the Commission. FIA requests that the Commission withdraw this proposed requirement from any final rule because it adds another layer of reporting obligations to an already complex reporting regime.

The Commission stated in the NOPR that the position visibility reporting requirement would affect only a few market participants, but acknowledged that it currently receives data for its market surveillance needs on the largest positions in referenced base and precious metals and energy contracts.[29] FIA recommends that, instead of creating another reporting requirement for positions in these markets, the Commission wait until after it has had an opportunity to receive, review, and analyze data that will be reported as a result of the requirements in its many proposed rules for designated clearing organizations, swap execution facilities, swap data repositories, swap dealers, and major swap participants. The Commission likely will find then that it has all of the position data that it needs to fulfill its market surveillance responsibilities. Furthermore, if the Commission adopts FIA's accountability level proposal instead of setting hard limits for single month and all-months-combined positions, the proposed position visibility regulations would not be needed because the Commission would be able to request and receive the same information from a market participant that exceeds the accountability level for a Referenced Contract.

VII. The Commission Should Exercise Its Authority to Define *Bona Fide* Hedging Transactions Consistently with Existing Commercial Risk Management Practices and Grant Exemptions to Liquidity Providers

FIA recommends that the Commission define *bona fide* hedging transactions and positions more broadly so that the definition will encompass long-standing and important commercial risk management practices. The Commission also should re-institute a process by which hedgers can seek exemptions for non-enumerated hedging transactions and permit anticipatory hedge exemptions for positions in exempt commodities for periods exceeding one year. We also recommend that the Commission modify the reporting requirements applicable to *bona fide* hedgers. Finally, FIA requests that the Commission implement a process by which liquidity providers may obtain hedge exemptions from speculative position limits.[30]

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[29] *See id.* at 4763.

[30] The Commission has express authority under the CEA to define *bona fide* hedging transaction in a manner that reflects sound risk management practices and to permit non-enumerated hedging transactions. CEA Section 4a(c)(1) exempts *bona fide* hedging transactions from any speculative position limits established by the Commission. In Section 737(c) of the Dodd-Frank Act, which added new Section 4a(c)(2) to the CEA, Congress for the first time identified the parameters that the Commission must use to define *bona fide* hedging transactions "for the purposes of implementation" of limits on agricultural and exempt commodity futures contracts, options on futures contracts, and OTC options. At the same time, in new Section 4a(a)(7), Congress gave the Commission very broad authority to "exempt, conditionally or unconditionally, any person, or class of persons, [and] any [Referenced Contract]" from any speculative position limits it sets under Section 4a(a)(2).

A. The Commission Should Propose a Broader Definition of *Bona Fide* Hedging That Is Consistent with Long-Standing Commercial Risk Management Practices

According to the Commission, because new Section 4a(c)(2) omits the word "normally" that appears in current CFTC regulation 1.3(z), transactions or positions qualify as *bona fide* hedges "only if such transactions or positions represent cash market transactions and offset cash market risks. . . ."[31] FIA submits that the Commission's interpretation of the statutory definition is overly restrictive, does not take into account the Commission's broad exemptive authority in Section 4a(a)(7), and is inconsistent with long-standing commercial risk management practices.

1. The Commission Should Not Restrict Bona Fide Hedges to Enumerated Hedging Transactions

The practical problems for commercial hedgers created by the Commission's overly restrictive interpretation of its authority to define *bona fide* hedging transaction are compounded by the text of the proposed definition. For example, the Commission has eliminated the mechanism in former Regulation 1.3(z)(3), by which a hedger could apply for an exemption for non-enumerated hedging transactions. This change, combined with the requirement in Proposed Rule 151.5(a)(1)(iv)(B) that "no transactions or positions shall be classified as bona fide hedging . . . unless . . . the provisions of paragraph (a)(2) [listing enumerated hedging transactions] have been satisfied" means that the definition of *bona fide* hedging transaction in Proposed Rule 151.5(a)(1) effectively is limited to enumerated hedging transactions (the "Enumerated Transaction Limitation").[32]

Because the Commission's list of enumerated hedging transactions refers only to ownership, sales and purchases of the underlying commodity or Referenced Contracts, it is at best unclear whether hedges of inventory or other assets that a hedger anticipates owning qualify as *bona fide* hedging transactions under the Enumerated Transaction Limitation. Similarly, it is unclear whether hedges of liabilities or services that a hedger anticipates incurring, providing or purchasing qualify as *bona fide* hedges. For example, it appears that, because of the Enumerated Transaction Limitation, the following hedges would not qualify as *bona fide* hedges even though they satisfy the requirements of Proposed Rule 151.5(a)(1):

- a company that has purchased firm transportation service from point A to point B on a natural gas pipeline, hedging the value of that service by buying or selling a spread based on the value of natural gas at points A and B;
- a company that anticipates entering into a fixed-price sale of a cash commodity, hedging that anticipated liability by purchasing a Referenced Contract;

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[31] 76 Fed. Reg. at 4761.

[32] Under Regulation 1.3(z), the broader definition of *bona fide* hedging transaction in (a)(1) remained viable because the Commission retained the authority to grant exemptions for non-enumerated hedging transactions.

- a party to a volumetric production payment transaction that anticipates owning oil or natural gas, but not until it is extracted some time in the future, and then selling the commodity, hedging its price risk until it actually owns the commodity.

Furthermore, when one examines the differences between subsections (a)(1) and (a)(2), it appears that hedges of assets that a person merchandises or anticipates merchandizing are not included in the Enumerated Transaction Limitation. This will reduce the ability of marketers of energy, metal and agricultural commodities to hedge the risks associated with their businesses.

More significantly, the Commission's list of enumerated hedging transactions does not appear to include the swap transactions that are expressly included in Proposed Rule 151.5(a)(1)(iv) and CEA § 4a(c)(2)(B). At a minimum, it does not include swaps used to hedge "[s]ales of any underlying commodity."[33] Thus, the Enumerated Transaction Limitation appears to eliminate the statutory exemption in CEA § 4a(c)(2) for hedges of swaps that qualify as *bona fide* hedges under Proposed Regulation 151.5(a)(1)(i) through (iii) for a person's swap counterparty. The Enumerated Transaction Limitation similarly seems to eliminate the ability of a person to hedge certain swaps that qualify for the end-user clearing exception.[34] These consequences, whether intended or unintended, will disrupt existing commercial market practices, reduce liquidity in listed and OTC derivatives markets, and may increase systemic risk by effectively making it too difficult for market participants to hedge cash and swap market risks.

If, contrary to the recommendations of FIA and many other market participants, the Commission will no longer grant exemptions for non-enumerated hedging transactions, it should delete the prohibition in subsection (a)(2)(v) against holding cross-commodity hedges during the last five trading days of any referenced contract. Otherwise, the Proposed Rule will have the

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[33] Rule 151.5(a)(2)(i). In fact, the Commission's list of enumerated hedging transactions also seems to eliminate Referenced Contracts as a hedge in this subsection. Regulation 1.3(z)(2)(i) refers to sales of futures contracts, rather than sales of the underlying commodity.

[34] In its proposed rule further defining swap dealer, the Commission defined "hedging or mitigating commercial risk" to include any swap that:

- qualifies as a bona fide hedging transaction;
- qualifies for hedging treatment under FASB Accounting Standards Codification Topic 815; or
- is economically appropriate to the reduction of risks in the management of a commercial enterprise (*e.g.*, the swap hedges potential changes in the value of assets or liabilities).

Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant," 75 Fed. Reg. 80174, 80214-15, RIN 3038-AD06 (Dec. 21, 2010). The Enumerated Transaction Limitation appears to disqualify hedges of swaps that satisfy the second and third prongs of the definition of commercial risk from treatment as *bona fide* hedging transactions.

effect of forcing market participants to assume risks that they currently shift to other market participants who are willing to assume those risks. For example, a commercial company hedging jet fuel price exposure with heating oil futures contracts (or with a heating oil swap that a dealer, in turn, hedges with heating oil futures contracts) will be forced to go un-hedged during the last five days of the spot month. Such a restriction will reduce market liquidity and increase the risk of operating a commercial business.

2. *Hedgers Should Be Permitted to Apply for Anticipatory Hedge Exemptions for Periods Longer Than One Year*

As currently drafted, the text of Proposed Rule 151.5(c) appears to restrict anticipatory hedge exemptions to transactions (as opposed to the exemption itself) that do not exceed one year. For example, subsections (c)(iv) and (v), which relate to anticipated production or requirements, and unsold anticipated production or unfilled anticipated requirements, both reference "the period hedged, which may not exceed one year."[35] While this may not be what the Commission intended, by placing the "which" after "the period hedged," the Commission has limited the portion of a long-term transaction that can be hedged to a one-year period. This restriction would be commercially unworkable for infrastructure projects that require multi-year hedges in order to secure financing. For example, hedges of anticipated power plant production and fuel requirements that provide support for acquisition financing often extend for ten years or longer. Purchasers of such assets should be able to enter into long-term, anticipatory hedges. FIA recommends, therefore, that the Commission delete the language "which may not exceed one year" from the end of each of subsections (c)(iv) and (v) of Proposed Rule 151.5.

3. *The Commission Has and Should Exercise the Authority to Define Bona Fide Hedging Transactions More Broadly for Swaps*

Although not required by CEA Section 4a(c)(2), the Commission's proposed definition of *bona fide* hedge transaction would apply not only to futures, options on futures, and OTC options, but also to swaps.[36] In the NOPR, the Commission explained that it included swaps because "[a] definition of bona fide hedging that would exclude swaps would deny a commercial end-user the option of offsetting price risks with swaps (as opposed to futures) pursuant to a *bona fide* hedge exemption."[37] FIA submits that another alternative is available to the Commission. Apart from requiring in CEA Section 4a(c)(1) that the definition of *bona fide*

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[35] Unlike proposed Rule 151.4(a)(2)(i)(B), which limits the one year restriction to agricultural commodities, subsections (c)(iv) and (v) appear to apply to the commodities underlying all core referenced contracts.

[36] 76 Fed. Reg. at 4760.

[37] *Id.* at 4760.

hedging transaction be consistent with the purposes of the CEA, Congress placed no restrictions on how the Commission should define *bona fide* hedging transaction for any Referenced Contract other than futures, options on futures, and options on commodities. As a result, the Commission has broad discretion to define *bona fide* hedging transaction for swaps. Thus, rather than applying the same restrictive definition of *bona fide* hedging transactions to swaps and futures, the Commission should use the authority granted to it by Congress to propose a broader definition of *bona fide* hedging transaction to swap positions. A broader definition for swaps would provide market participants with more flexibility to manage risks with swaps executed on DCMs or SEFs, or with bilateral OTC swaps.[38]

B. The Commission Should Enable Liquidity Providers to Apply for Hedge Exemptions

In its pre-rulemaking comments, FIA requested that the Commission propose a process that it would follow and the criteria that it would consider in determining whether to grant requests by market participants for exemptions from position limits. As FIA noted above, Section 4a(a)(7) provides the Commission with broad authority to exempt, conditionally or unconditionally, any person or class of persons and any class of Referenced Contracts from any speculative position limits that it sets under Section 4a. FIA believes, like many others who have submitted comments, that the Commission should use its authority to grant risk management exemptions in appropriate circumstances.

Now that the Commission has broad authority to obtain information about the swap positions of all market participants, monitor their positions across instruments and markets and subject them to limits as appropriate, the Commission's prior concerns about permitting dealers and other market participants to hedge the risks they incur when entering into swaps with persons seeking exposure to commodity market prices no longer apply. Passive investors bring much needed liquidity to the listed and OTC derivatives markets. They are willing to assume the risks that hedgers seek to transfer. Their presence in the derivatives markets enhances the efficiency of the price discovery function of those markets. And, as noted above, there is no objective evidence that their participation in the markets has caused volatile commodity market prices.

Dealers and other market participants that enter into swaps with passive investors incur price risk related to the underlying commodities. For this reason, FIA reiterates its recommendation that the Commission should propose and seek comments on the factors it should consider in deciding whether to grant hedge exemptions to liquidity providers who enter into swaps with customers in circumstances where their hedge of the risks associated with the

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[38] Because CEA § 4a(c)(2)(B) requires that, to be eligible for the pass-through hedge exemption, a swap must satisfy the requirements of CEA § 4a(c)(2)(A), swaps that meet a broader definition of *bona fide* hedging transactions may not be eligible for the pass-through exemption. Nevertheless, a broader definition of *bona fide* hedging transaction for swaps still would provide market participants with more flexibility to hedge the risks they incur in their businesses.

swap position may not fall squarely within the statutory definition of *bona fide* hedging position.[39]

Exemptions from position limits should be available for positions that serve the same function as *bona fide* hedging transactions and positions – *i.e.*, they manage risk and, therefore, promote the financial stability of providers of swaps and other risk management instruments to their customers and counterparties. Unless the Commission announces and seeks comments on a process by which market participants can apply for an exemption from speculative position limits, liquidity providers will have to hedge the risks associated with risk management positions within speculative position limits. Thus, they will either have to assume those risks themselves, find alternative, perhaps foreign, markets in which to hedge that risk, or reduce or abandon the risk management products and services that they provide to their customers. In either case, the liquidity and price discovery function of Referenced Contracts likely will be diminished or disrupted, a result that may contribute to price volatility and less efficient markets.

C. Persons Hedging Swap Position Risk Should Be Permitted to Rely upon a One-Time Representation from Their Swap Counterparty That the Swap Is a *Bona Fide* Hedge

Proposed Regulation 151.5(g) provides that a person intending to rely upon a *bona fide* hedge exemption (the "Hedger") to hedge the risk associated with a swap with a counterparty (the "Swap Counterparty") that "is relying on a *bona fide* hedge exemption *to exceed the position limits* of § 151.4" must obtain a representation from the Swap Counterparty that the swap "qualifies as a bona fide hedging transaction" and provide written confirmation of such representation to the Swap Counterparty, apparently on a transaction-by-transaction basis.[40] It is unclear whether the Hedger must wait until all written communications have been exchanged before it can enter into a hedging transaction without fear that it will be disqualified after-the-fact and potentially cause the Hedger to exceed the speculative position limit. If the swap is a hedge for both parties, Proposed Regulation 151.5(g)(1) requires both parties to satisfy the representation-confirmation process, even though neither party needs to rely on the swap risk pass-through exemption provided in CEA Section 4a(c)(2)(B).

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[39] We are concerned that the position limits proposal, if adopted as drafted, could harm commodity index funds, by limiting the hedging services provided by financial intermediaries to commodity index funds. Commodity index funds serve a very important role in the commodity markets, creating liquidity and facilitating price discovery. Furthermore, unlike other large market participants, commodity index funds are subject to extensive regulation by the SEC, many as registered investment companies pursuant to the Investment Company Act of 1940. As such, these funds are fully collateralized, highly regulated, and pose little or no systemic risk to the market. The proposed position limits, including the limits on risk management and the limits on financial intermediaries' hedging will have a serious adverse effect on the ability of financial intermediaries to service commodity index funds, and we urge the Commission to ensure that position limits will not restrict financial intermediaries services to commodity index funds.

[40] Proposed Rule 151.5(g) (emphasis added).

FIA has a number of concerns with Proposed Regulation 151.5(g). We assume that the Commission did not intend to limit the swap pass-through hedge only to transactions where the Swap Counterparty "is relying on a *bona fide* hedge exemption *to exceed the position limits*." The text of CEA Section 4a(c)(2)(B)(i) only requires that the underlying swap "qualify as a *bona fide* hedging transaction" without regard to whether the Swap Counterparty is below or above any speculative position limit set by the Commission. Moreover, CEA Section 4a(c)(1) expressly precludes the CFTC from placing position limits on *bona fide* hedging transactions regardless of whether a party's total positions are below or above the applicable speculative position limit. Accordingly, FIA recommends that the Commission revise the introductory paragraph of Regulation 151.5(g) to read as follows:

> "Upon entering into a swap transaction opposite a counterparty for which the swap qualifies as a *bona fide* hedging transaction:"

We believe that our proposed language is consistent with the Commission's intent as evidenced by the text of Proposed Regulation 151.5(g)(i), and the plain language of CEA Section 4a(c)(2)(B)(i), both of which refer only to a swap that qualifies "as a *bona fide* hedging transaction."

Furthermore, several aspects of this proposed requirement are commercially impractical in markets where a Hedger seeks to protect itself against complex and rapidly changing risks. Indeed, this requirement effectively would force a Hedger to assume the risk of price changes (*i.e.*, speculate) during the period between when it enters into a swap with a Swap Counterparty and when the parties complete the written documentation process. Or if, as is likely to be the case under the proposed regulation, the Hedger declines to enter into the swap until after the parties have completed the written documentation process, it would force the Swap Counterparty to assume the same price risk. Neither result makes commercial sense.

Consistent with the many comments that the Commission has received from market participants concerning the proposed regulations implementing the end-user clearing exception, the Commission should modify proposed Regulation 151.5(g) to allow a Hedger to rely upon a one-time representation from a Swap Counterparty that each uncleared swap that it enters into with the Hedger qualifies as a *bona fide* hedging transaction for the Swap Counterparty.[41] Similarly, the Hedger should only have to provide the Counterparty with a single confirmation of its receipt of the Counterparty's representation.[42] The Commission also should make clear that

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41 In the alternative, FIA supports ISDA's recommendation that the Swap Counterparty, like any party seeking a *bona fide* hedge exemption, be certified by the Commission rather than by a representation from the Swap Counterparty to the Hedger.

42 The Commission also should consider replacing the term "cash market commodity risk" with "commercial risk" to align Proposed Rule 151.5(g) with the end-user clearing exception.

Regulation 151.5(g) does not apply when both parties are using a swap to hedge a cash market commodity risk.[43]

D. Persons Relying on *Bona Fide* Hedge Exemptions Should Only Be Required to File Reports When They First Exceed the Position Limit and then Monthly Thereafter

Instead of allowing traders to apply for hedge exemptions in advance — a long-standing practice of the Commission and the exchanges — proposed Regulations 151.5(b) and (i)(in the case of swaps) would require traders who exceed a position limit in reliance on the exemption for *bona fide* hedging transactions to file detailed reports with the Commission by 9:00 am, presumably in the Eastern US time zone, on the next business day for every day on which they exceed the limit. This requirement will create substantial commercial and operational difficulties for market participants and the Commission.

From a commercial perspective, it is unclear what would happen if after having submitted the required reports for an extended period, Commission staff contacted a hedger to raise questions about the extent to which the hedger exceeded the applicable position limit. As noted above, the risks incurred by commercial businesses are very dynamic. Often times, hedges of those risks do not correspond precisely in time or quantity. If a refinery needed to hedge the anticipated purchase of a cargo of crude oil in a volatile market, it would be impractical to wait until after resolving any questions raised by staff to place the hedge. At that point, the cost of purchasing the cargo may have increased substantially due to changes in market prices. Without a hedge to protect against that price increase, the refiner will have to pass the increased cost of the refined product to wholesale purchaser who, in turn, will pass along the increased cost to retail customers.

From an operational perspective, a conglomerate with multiple international offices, operating in multiple time zones, and trading Referenced Contracts on multiple platforms and in multiple OTC markets would have to track, and in some cases aggregate, on a daily basis all of its spot, single month and all-months-combined positions, run IT systems in multiple time zones, synthesize the data, and prepare and submit reports with all of the information required by Proposed Rule 151.5(b), all by 9:00 am, and then repeat that process every day.[44] This same

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[43] FIA also recommends that the Commission eliminate the requirement in Proposed Regulation 151.5(j)(2) that persons only be permitted to hedge swaps that continue to offset the risk of a *bona fide* hedging counterparty. Commercial market participants are unlikely to want to disclose all of the adjustments that they make to their underlying and hedging transactions to their swap counterparties. In addition, if a commercial party hedges a large commercial risk by entering into swaps with multiple dealers and later adjusts its underlying cash market position, it may be impractical to reduce all swaps with those dealers pro rata or even independently. Because the Commission will receive position data directly from traders, it should be in a position to monitor the positions of the commercial party.

[44] FIA notes that these same operational complexities will also impact the ability of market participants to aggregate and monitor positions to comply with limits on an intra-day basis. FIA requests that the Commission consider providing some flexibility, such as a reasonable time period, for a market participant who finds that a position may have exceeded a limit to adjust the position within the limit.

process will place a tremendous burden on the Commission's own limited resources. In the current budget environment, it is unclear whether the Commission will have the staff and IT resources to review all of the data it proposes to require market participants to submit on a daily basis. The costs of the Commission's proposed reporting requirements likely will outweigh the benefits.

FIA encourages the Commission to consider a less resource-intensive process for collecting the information it needs to perform its market surveillance responsibilities. In the NOPR, the Commission asks whether it should "only require reports to be submitted either when a trader's position [either][sic] first exceeds a limit or when a trader's hedging need increases, with a monthly summary while the trader's position remains in excess of the limit?"[45] FIA recommends that the Commission require reports to be filed only when a trader's position first exceeds a limit. Thereafter, the Commission only should require a trader to submit a monthly summary while the trader's position remains in excess of the limit, which is consistent with the Commission's current requirement in Section 19 of the Regulations for series '04 reports. And, if necessary, the Commission can request additional information from a trader at any time.

VIII. The Commission Should Modify Its Proposed Aggregation Requirement to Permit Independent Account Controllers and Financial Entities to Apply for Exemptions

The Proposed Rule eliminates the independent account controller exemption in part 150 of the Commission's regulations, and contains a limited exemption from mandatory aggregation that would allow an entity to disaggregate (1) the positions of a non-financial entity in which it holds a ten percent or greater equity interest from (2) its own directly held or controlled positions, if it can demonstrate to the Commission that the owned non-financial entity "is independently controlled and managed."[46] FIA has a number of significant concerns about the Commission's proposed account aggregation standards.

First, FIA strongly recommends that the Commission reinstitute a robust independent account controller exemption from mandatory aggregation. There is no evidence that the Commission's long-standing independent account controller exemption and related aggregation policies should be more restrictive as proposed by the Commission. Second, although FIA appreciates the Commission's proposal to provide a limited exemption from the aggregation requirement for owned non-financial entities, the NOPR provides no explanation for the Commission's decision not to afford this same opportunity to financial entities. Sound public

[45] 76 Fed. Reg. at 4761.

[46] 76 Fed. Reg. at 4762.

policy supports providing a non-discriminatory opportunity to all trading entities that can satisfy reasonable criteria for an exemption from the aggregation requirement.[47]

A. The Commission Should Reinstitute Its Long-Standing Independent Account Controller Exemption

The Commission's Proposed Rule eliminates the independent account controller exemption in Part 150 of the Commission's regulations.[48] This proposed change in the Commission's aggregation rules will have a substantial adverse impact on "eligible entities," as defined in current Rule 150.1(d), including the affiliates of FIA members, who have operated their businesses for more than two decades in reliance on the Commission's existing position limit and aggregation rules.

When an administrative agency departs from long-standing rules, it must provide the public with a reasoned explanation for its new policy.[49] The explanation provided by the Commission in the NOPR for its proposal to eliminate the independent account controller exemption is not sufficient. According to the Commission, the independent account controller exemption "may be" incompatible with its proposed Federal position limit scheme "and used to circumvent its requirements."[50] The Commission cited its proposed "high position levels," which as noted above do not comply with the requirements of CEA § 4a(a)(1), as support for its observation that "allowing traders to establish a series of positions each near a proposed position limit, without aggregation, may not be appropriate."[51]

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[47] In the NOPR, the Commission asks if it should grant exemptions from account aggregation under its exemptive authority in CEA Section 4a(a)(7). Section 4a(a)(7) provides the Commission with broad authority to exempt, conditionally or unconditionally, any person or class of persons and any class of Referenced Contracts from any speculative position limits that it sets under Section 4a. As part of the Commission's effort to implement Congress' directive to ensure sufficient liquidity in, and to protect the price discovery function of, the listed and OTC derivatives markets, the Commission should use this authority to apply position limits separately to accounts that are subject to separate management and control. Allowing independently controlled accounts to trade within speculative position limits will promote more liquid markets and more efficient price discovery, and at the same time, will preclude intentionally coordinated trading activity that might lead to excessive speculation or price manipulation.

[48] *Id.* at 4762.

[49] *See Ramaprakash v. FAA*, 346 F.3d 1121, 1124 (D.C. Cir. 2003) (overturning a decision by the Federal Aviation Administration because "agency action is arbitrary and capricious if it departs from agency precedent without explanation. Agencies are free to change course as their expertise and experience may suggest or require, but when they do so they must provide a 'reasoned analysis indicating that prior policies and standards are being deliberately changed, not casually ignored.'" (citing *Greater Boston Television Corp. v. FCC*, 444 F.2d 841, 852 (D.C. Cir. 1970)); *see also Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 34 (1983) (holding that the National Highway Traffic Safety Administration acted arbitrarily and capriciously because "the agency failed to present an adequate basis and explanation for rescinding" a prior regulation).

[50] 76 Fed. Reg. at 4762.

[51] *Id.*

There are at least four significant flaws in the Commission's position. First, and most important, it ignores the fact that the Commission's authority to grant exemptions from position limits under new CEA § 4a(a)(7) is even broader than it was when the Commission first granted the independent account controller exemption. Second, the Commission relied on its own legally infirm proposed limits as support for this radical departure from long-standing regulations and agency practice. Third, the Commission does not explain how independently controlled accounts could or would circumvent the Commission's proposed position limit regime. And fourth, independently controlled trading and positions pose no threat of coordinated excessive speculation or market manipulation.

The Commission also stated that the "self-executing nature" of the independent account controller exemption "creates an insufficient and inefficient verification regime" and reduces the Commission's "ability to properly perform its market surveillance responsibilities."[52] The simple way to address the Commission's stated concern would be to expand the Commission's proposal to permit non-financial entities to apply for an exemption from aggregation to include "eligible entities," and require them to request an exemption.[53] As proposed by FIA below, an application by an eligible entity for an exemption from the aggregation requirement should be conditionally effective when filed.

B. The Commission Should Permit Disaggregation of the Accounts of All Independently Controlled and Managed Entities

The NOPR does not provide the public with notice of any rationale for the Commission's proposal to deny financial entities an opportunity to disaggregate even if they can satisfy the same criteria for disaggregation applicable to owned non-financial entities. Without a rational basis for the Commission's proposed disparate treatment of financial entities, it is unlikely that the Proposed Rule complies with the requirements of the Administrative Procedure Act.[54] Moreover, there is no sound public policy basis for the Commission's proposed discriminatory treatment of financial entities. As FIA pointed out in its earlier comments, many other federal agencies disaggregate ownership interests in appropriate circumstances for purposes of

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[52] *Id.* at 4762.

[53] The term "eligible entities" as defined in current Section 150.1 of the Commission's Regulations includes: commodity pool operators, those qualified for exemption from the definition of commodity pool operators, commodity trading advisors, banks or trust companies, savings associations, insurance companies, or the separately organized affiliates of any of these entities.

[54] *See supra* n.16.

measuring the ability of one affiliate to control the activities of another affiliate.[55] Significantly, these other federal agencies, several of which regulate financial entities, do not distinguish between financial and non-financial entities for purposes of determining who is eligible for their respective exemptions.

The Proposed Rule also fails to take into account other regulatory, fiduciary and contractual requirements that prohibit common control of accounts managed by financial entities. For example, as FIA pointed out in its October 1, 2010 pre-rulemaking comments, financial institutions, many of which have FCM affiliates, maintain barriers to prevent the flow of information between and among affiliates, including affiliates that control the trading of, and have fiduciary duties to, third parties. In order to aggregate the positions of these separately-controlled, but commonly owned entities, they would have to share position and trading information to which they otherwise would not or should not have access. Furthermore, a company with an affiliate that underwrites securities offerings may not know that its affiliate has acquired a temporary, passive interest in another company that also trades commodities. Under the Commission's proposal, the first company would be required to share trading information and allocate position limit capacity with a temporary affiliate that may be one of its direct competitors and that previously controlled its own trading independently from its competitor. In each of these examples, the costs of requiring aggregation of independently controlled accounts greatly outweigh the unarticulated regulatory benefits.

FIA respectfully recommends that the Commission permit financial entities to disaggregate positions in separately controlled accounts to the same extent as non-financial entities. There is no legal or policy reason why the same or similar procedures and controls proposed by the Commission to ensure independent management of accounts by non-financial entities should not be permitted for financial entities.

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[55] In analogous circumstances, other federal regulators generally permit disaggregation of holdings of financial entities where positions are independently controlled or where appropriate informational barriers are in place between their business units. For example, the SEC does not attribute ownership to a parent entity when it has in place "informational barriers that ensure that voting and investment powers are exercised independently from parent and affiliated entities." Amendments to Beneficial Reporting Requirements, Exchange Act Release No. 34-39538, 63 Fed. Reg. 2,854, 2857-58 (Jan. 12, 1998) (noting that "procedures reasonably designed to prevent the flow of information to and from other business units" may be relied upon "to avoid attributing beneficial ownership to the parent entities."). Similarly, the Federal Energy Regulatory Commission ("FERC") recently proposed to not attribute control to a parent company, including a financial entity, that owns less than 20 percent of the voting securities of an affiliated public utility when there is separate control of the two entities. *See e.g.*, FERC Docket No. RM09-16 (proposed blanket authorization for any investor to acquire less than 20% of a public utility's voting securities and receive waiver of certain restrictions applicable to affiliates if the owner of such securities files an affirmation disclaiming its ability to control the public utility.) The Federal Reserve Board definition of affiliate does not attribute control based upon share ownership at a level below 25 percent. *See* 12 C.F.R. 255.2 ("Control" of an "Affiliate" means the "[o]wnership, control, or power to vote 25 percent or more of the outstanding shares of any class of voting securities" of a company, whether directly or indirectly or acting through one or more other persons.).

C. The Requirements for Obtaining an Exemption from the Aggregation Requirement Are Broader than Necessary

The Commission proposes to require entities seeking an exemption from the aggregation requirement for owned non-financial entities to demonstrate in a very detailed application that the owned non-financial entity is independently controlled and managed.[56] Significantly, the exemption would not be self-executing. Instead, it would only be effective once the Commission approves the application.[57]

1. Exemptions Should Be Conditionally Effective upon Filing of Application Providing the Information Required in the Final Rule

We expect that the Commission is likely to receive hundreds of detailed applications for exemptions from the aggregation requirement. Reviewing and approving these applications will be a significant burden on the Commission's limited resources and could result in long delays in processing and approving applications. In the interim, as proposed by the Commission, applicants will have to aggregate positions even in separately controlled accounts.

FIA respectfully requests that the Commission amend its proposed regulation to provide that an exemption application is conditionally effective when filed with the Commission. Persons who file applications with the Commission are subject to Section 9(a)(3) of the CEA which makes it a felony, punishable by a substantial fine or imprisonment, for any person knowingly to misrepresent or omit a material fact in any application required to be filed under the CEA. Section 9(a)(3) provides applicants with sufficient incentive to file complete and accurate applications for exemptions. Allowing the exemption to be conditionally effective once the application is filed would enable market participants to disaggregate positions while awaiting formal approval of the application by the Commission. FIA's proposed approach would promote increased market liquidity and more efficient price discovery.

If, for some reason, the Commission ultimately declines to approve an application for exemption, the applicant should be given a reasonable period of time within which to aggregate positions in the relevant accounts and comply with the applicable speculative position limits. The Commission also should provide a safe harbor against enforcement action for persons who apply in good faith for an exemption from the aggregation requirement even if the Commission decides not to approve the application.

2. Companies Should Be Permitted to Manage Risk Across Affiliated Entities

FIA supports most of the proposed requirements for demonstrating that the trading of entities seeking an exemption from the aggregation requirement are "independently controlled

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[56] 76 Fed. Reg. at 4762.

[57] *Id.*

and managed."[58] However, FIA requests that the Commission clarify that affiliated entities may manage risk across entities by relying upon common risk management personnel and systems. It is unclear, for example, whether the following, among other, requirements in Proposed Rule 151.7(f) and (g), when viewed in combination, preclude affiliated entities from managing risk with common personnel and information:

- the "entity" must have policies and procedures that preclude it and its affiliates from having knowledge of, gaining access to, or receiving information about its positions or trades;[59]
- the two entities must maintain separate risk management systems;[60]
- the "entities" must file an application:
    - designating an office or employee of the "entity" responsible for coordination of position limit and aggregation compliance;[61]
    - providing the names of compliance and risk management employees of the "entity" and their locations.[62]

Many holding companies and conglomerates use centralized groups and reports to manage the many risks that their affiliated businesses incur. For example, some companies create and use concentration reports to manage the exposures that multiple affiliates may have to particular commodities or designated clearing organizations. This is a sound risk management practice that the Commission should encourage, rather than discourage. Furthermore, multi-affiliate companies should be permitted to design their own risk management systems and procedures that will enable them to comply with the regulatory regimes of U.S. and international regulators. As long as the risk management function is performed by personnel who do not control the trading decisions of other affiliates and who do not share trade or position information with the persons who control the trading of the separate affiliates, the Commission's goal of ensuring independent control and management of trading and positions will be satisfied.

3. The Commission Should Not Require Applicants for an Exemption to Submit an "Independent Assessment Report"

The Proposed Rule requires applicants to submit, but does not define the parameters of, an "independent assessment report" on the operation of the applicant's policies and procedures for ensuring separate management and control of trading decisions by entities seeking disaggregation. FIA is concerned that it will be expensive and time consuming to hire and educate a consultant about a company's internal policies and procedures for ensuring separate

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58 *See* Proposed Rule 151.7(f)(1)–(3).

59 Proposed Rule 151.7(f)((3).

60 *See* Proposed Rule 151.7(f)(4) and 76 Fed. Reg. at 4763.

61 Proposed Rule 151.7(g)(iii).

62 Proposed Rule 151.7(g)(v).

management and control of trading decisions. Applicants for an exemption are in the best position to know if their policies and procedures comply with the Commission's final requirements for disaggregation. FIA requests that the Commission either eliminate this requirement, or allow persons who are responsible for a company's risk management function and who are independent from the trading function to prepare the report.

4. Market Participants Should Be Allowed to Determine How to Ensure that Companies with Independent Control over Trading and Positions Comply with the Commission's Aggregation and Position Limit Rules

Rather than requiring applicants to designate an office and employee(s) to be responsible for coordinating compliance with aggregation rules and position limits, FIA requests that the Commission allow applicants the flexibility to determine for themselves how they best can ensure that they comply with the requirements for an exemption. Market participants vary significantly in terms of their trading organizations and compliance resources. The Commission's principal concern should be that market participants comply with the conditions for an exemption from the aggregation requirement, rather than how they do so.

IX. Conclusion

For the foregoing reasons, FIA respectfully requests that the Commission withdraw the Proposed Rule until after it has collected and analyzed the information it needs to determine whether position limits for Referenced Contracts are "necessary," and if so, whether its proposed limits are "appropriate." In the alternative, FIA requests that the Commission adopt FIA's recommended revisions to the Proposed Rule before issuing final position limit regulations.

Please direct any questions about FIA's comments and recommendations to Barbara Wierzynski, Executive Vice President and General Counsel, at 202-466-5460.

Respectfully yours,

John M. Damgard
President

cc: Honorable Gary Gensler, Chairman
Honorable Michael Dunn, Commissioner
Honorable Jill E. Sommers, Commissioner
Honorable Bart Chilton, Commissioner
Honorable Scott O'Malia, Commissioner
Daniel Berkovitz, General Counsel
Terry Arbit, Deputy General Counsel, Office of the General Counsel
Stephen Sherrod, Acting Director of Surveillance
Bruce Fekrat, Special Counsel