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COMMENT
CL-02682

DRW TRADING GROUP

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USA

April 26, 2010

Mr. David Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Proposed Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations (January 26, 2010)

Dear Mr. Stawick:

DRW Trading Group ("DRW") appreciates the opportunity to respond to the request by the Commodity Futures Trading Commission (the "CFTC") for comments on its Proposed Rule on Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations (the "Proposal").

DRW is a principal trading organization that trades a wide range of asset classes in the United States and abroad. DRW is an active liquidity provider in several of the referenced energy products. DRW's energy trading activity is limited exclusively to centrally cleared products, including Natural Gas and Crude Oil futures and options markets.

The CFTC asks if "Federal speculative position limits for energy contracts traded on reporting markets [are] necessary to 'diminish, eliminate, or prevent' the burdens on interstate commerce that may result from position concentrations in such contracts." The answer to this question is a resounding "no" for the following reasons:

1. Adoption of the proposal would set a dangerous precedent of permitting the government to intervene in the price discovery process without justification.
2. The Proposal compromises free market principles.
3. The Proposal is anti-competitive in that its open interest formula places smaller exchanges at a competitive disadvantage to larger, established exchanges.

1. The Proposal Sets a Dangerous Precedent

The debate about position limits has been clouded by the comingling of two very distinct policy objectives: avoiding "congestion" in certain commodities, and influencing the price of those commodities by regulating speculation. However, it has not been shown that speculation was the cause of the 2008 increase in the price of crude oil. Therefore, to adopt the Proposal would be flawed policy and would set a dangerous precedent of ad hoc, reactive government intervention in free markets without the requisite demonstration of a link between speculation and a "burden on interstate commerce".

Congestion and how exchanges effectively address it

Congestion happens when there is large open interest in a deliverable contract near expiration, and virtually all the participants on one side of the open interest (i.e., long or short) intend to go to delivery, while virtually all of the participants on the other side of the open interest intend to liquidate their positions. Congestion can create short term aberrations in the price and volatility of both the front month futures contract and the spot commodity. Such aberrations would clearly introduce burdens on interstate commerce.

Currently exchanges manage congestion by imposing position limits near expiration and accountability in all months. The exchanges are best situated to detect and address excessive concentrations and irregular positions or patterns. They have systems in place to allow for continuous monitoring of all participants' positions. Dislocations in the price of front month, physically delivered commodity futures contracts near expiration is a rare occurrence, which is a sign that the current system of exchange implemented positions limits works well.

If, in the future, the exchanges demonstrate that they are not effective in setting or enforcing limits or accountability levels to prevent the effects of congestion due to excessive concentrations, then the CFTC should intervene. Until then, the exchanges should continue to perform this role.

Price regulation and the CFTC's failure to show correlation between speculation and unnatural prices of energy derivatives

Distinct and separate from the issue of congestion is the issue of whether concentrated positions in the futures markets have impacted overall price levels. This second issue has been the matter of much debate, but it is important to distinguish it from congestion. Since the exchanges already effectively deal with congestion, it follows that the primary policy objective of the Proposal is to limit the possible influence of speculators on prices and the price discovery process of the commodities in question.

The CFTC has failed to establish that speculation reflected in concentrated positions in the futures markets causes prices to diverge from supply/demand fundamentals, thereby imposing a burden on interstate commerce. In fact, a report by the CFTC released in September 2008 concluded the

opposite.[1] In particular, it appears that the Proposal is offered in reaction to the rise in the price of Crude Oil to $145 per barrel in July of 2008. There is no credible evidence to suggest that anything but natural market forces drove the price of oil to its highs in 2008, and there is nothing to suggest that the Proposal would be effective in preventing such a rise in energy prices in the future.

2. The Proposal Compromises Free Market Principles

The Proposal limits freedom of market participants to allocate their portfolios

Market participants should be "free to choose" how to allocate their assets. Currently, many investors are legitimately concerned about the long term effects of the increased debt burden of the United States on inflation. A rational response to this concern is to diversify one's portfolio to gain some exposure to commodities, including energy commodities. Investors have several channels for attaining that exposure, including taking long positions in regulated futures contracts, entering bilateral OTC agreements, taking positions in contracts listed on foreign exchanges, purchasing ETFs, or buying physical energy assets.

The proposed limits on exchange traded futures contracts will force large investors to utilize other channels to attain their desired exposure. The effect of any of such activity on the supply/demand balance will be the same regardless of the means through which the exposure is obtained. In the best case, this will increase the cost and difficulty of portfolio diversification. In the worst case, the Proposal will be expanded to its logical conclusion and will limit the overall exposure a person can have to a commodity. This is traditionally known as rationing.

Left behind by the Proposal are small investors. Exchange Traded Funds (ETFs), such as the United States Oil Fund LP (USO), illustrate this point. Individual investors can buy USO shares in the public securities markets to gain exposure to crude oil. USO accepts funds from investors and attempts to replicate the returns of a long position in West Texas Intermediate Crude Oil (WTI). To achieve this, in part, USO takes long positions in WTI futures contracts. USO is comprised of thousands of individual investors. The Proposal, however, would consider the positions held by USO speculator. The lack of recognition of the fact that ETFs are an aggregation of numerous market participants is discriminatory against individual investors.

Treating an ETF as a single speculative position will result in two outcomes. First, many new and smaller ETFs (each carrying exposure below the position limits) will have to be established to meet the demand of individual investors. But the costs of managing a smaller ETF are per unit greater than the costs of managing a larger ETF. These costs are directly passed on to the investors of an ETF. Second, some energy ETFs (those at position limit) will trade at a premium to their net asset value because of the

[1] Commodity Futures Commission, Commodity Swap Dealers & Index Traders with Commission Recommendations (September 11, 2008) (http://www.cftc.gov/stellent/groups/public@newsroom/documents/file/cftcstaffreportson swapdealers09.pdf)

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inability to create additional shares. In any case, it will be more costly and difficult for smaller investors to allocate their portfolios to energy commodities.

Speculators serve an important, positive role in markets

The Proposal is by title designed to address speculation in energy contracts and, if adopted, would limit the ability of speculators to participate in the price discovery process. A healthy market requires all different kinds of market participants, including hedgers (hedging both long and short exposures in the underlying asset), dedicated liquidity providers, and speculators. Restricting the legitimate risk taking activities of either liquidity providers or speculators will undermine the benefits of exchange traded derivatives: transparency, price discovery and risk transfer.

Quite often the term "speculation" is confused with "manipulation". In fact, popular rhetoric often uses these terms interchangeably. However, speculation is positive and healthy, enabling the flow of capital from low-return activities to high-return activities. Limits on speculation result in suboptimal capital allocation. Manipulation is the deliberate effort to interfere with free and fair markets. Manipulation should be policed and punished. The Futures Industry Association, in its comment letter dated March 18, 2010, also addresses the important role of speculators in markets. I refer to that letter for further discussion on this topic.

3. The Proposal's Open Interest Formula is Anti-Competitive

The CFTC's proposed formula for determining the Single Month and All-Months Combined Limits is based on existing open interest on a per exchange basis, to be revised annually.[2] It serves as a barrier to entry for new exchanges, and a catalyst to drive more market share to the dominant exchange in cases of pre-existing competition.

Consider the following example: Financially settled WTI Crude futures contracts are currently listed on two major US exchanges – NYMEX and ICE. Neither would be considered a "small" or "new reporting market". On April 23, 2010, NYMEX's open interest in all months combined in the financially settled WTI Crude futures totaled 1,300,000 contracts, while that of ICE was 500,000. Under the Proposal, the "All-Months-Combined Limit" would be set to 34,300 for NYMEX, and 14,500 for ICE – less than half. Now consider a party that has a position of 25,000 in ICE financially settled WTI crude futures contracts. The Proposal would require that party to reduce its position on ICE to 14,500 contracts. To maintain the same economic exposure, the party would have to re-establish a position of 10,500 contracts on NYMEX. This reapportionment of open interest would give the dominant exchange an even a larger market share. Upon the recomputation of the position limits, the relative numbers would be again

[2] Under the Proposal, the All-Months-Combined Limit ("AMC Limit") would be 10% of the first 25,000 contracts of open interest and 2.5% of open interest beyond 25,000 contracts. The Single Month Limit ("SM Limit") would be set at 2/3 of the All-Months-Combined Limit. For a small reporting market, the AMC Limit would be up to 30% of a contract's total open interest on that exchange. The SM Limit that would apply to a single exchange would be equal to 2/3 of that value, or as much as 20% of the total open interest on that exchange. For new reporting markets, a de minimum AMC Limit would be the greater of 5,000 contracts or 1% of all open interest in a referenced energy commodity contract.

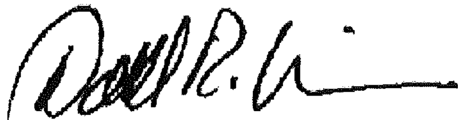
adjusted in favor of the larger exchange, resulting in further erosion of the smaller exchange's market share.

4. Conclusion

It is easy to understand why the CFTC has put forth the Proposal. The rise in energy prices in 2008 infuriated many Americans and members of Congress. With that kind of ire, speculators are a convenient scapegoat. It is much more difficult to accept that market forces drive prices and then examine the causes behind those forces. To start, there should be meaningful and nonpartisan dialogue on U.S. energy policy and the effects of government borrowing on the price of commodities.

The foundation of the American economy is free markets. If implemented, the Proposal would be a direct intrusion on the free market process. For the reasons stated herein, I ask the CFTC to reject the Proposal and allow the "Invisible Hand" to work. It has served our nation well.

Very truly yours,



Donald R. Wilson, Jr.
Founder and CEO,
DRW Trading Group

cc: Honorable Gary Gensler, Chairman
Honorable Michael Dunn, Commissioner
Honorable Jill E. Sommers, Commissioner
Honorable Bart Chilton, Commissioner
Honorable Scott O'Malia, Commissioner