FIA

Futures Industry Association
2001 Pennsylvania Ave. NW
Suite 600
Washington, DC 20006-1823

202.466.5460
202.296.3184 fax
www.futuresindustry.org

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

Re: Proposed Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations, 75 Fed. Reg. 4144 (Jan. 26, 2010)

Dear Mr. Stawick:

The Futures Industry Association[1] submits these comments on the Commodity Futures Trading Commission's Notice of Proposed Rulemaking entitled "Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations." For the many reasons set forth in this letter, FIA respectfully urges the Commission not to adopt its proposal. Instead, FIA requests that the CFTC defer any further action on its proposal until Congress completes its deliberations this session on financial regulatory reform legislation, which may include major changes to the provisions of the Commodity Exchange Act which authorize the Commission to impose position limits.

In the last decade, through a combination of aggressive enforcement and pervasive market surveillance, the Commission has continued to police effectively price manipulation and attempted manipulation, especially in the energy commodity markets. The combined CFTC and exchange systems, including large trader reporting, position accountability, targeted spot month position limits, special calls and constant vigilance, have worked and worked well. As new markets develop, whether over-the-counter or overseas, the Commission must adapt its market surveillance systems and Congress must update the Commission's authority, as it has done as

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1 For the record, FIA is a principal spokesman for the commodity futures and options industry. FIA's regular membership is comprised of approximately 30 of the largest futures commission merchants ("FCMs") in the United States. 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 eighty percent of all customer transactions executed on United States designated contract markets.

recently as 2008. FIA strongly supports these efforts. Price manipulation corrodes the public interests in price discovery and hedging. It can never be tolerated.

But speculation is not manipulation. Too often, our public debate on commodity prices misses this fundamental and irrefutable point. Instead, we hear that speculators have caused artificially high or low prices. Public relations campaigns to scapegoat speculators have fueled further misimpressions. Yet, FIA is not aware of any convincing or even credible evidence that large traders with speculative positions in energy futures markets have trumped market fundamentals as the determining factor in energy futures prices. Similarly, the CFTC's Federal Register Notice does not contain a finding that the proposed position limits are "necessary to eliminate or diminish" burdensome speculation, as the law contemplates. CEA § 4a(a).

The record actually supports just the opposite result: where position limits have been imposed we have observed no change in pricing patterns. FIA is not aware of any convincing or credible evidence that existing CFTC-set position limits have caused prices in agricultural markets to move in any materially different, let alone more fundamentals-driven, pattern than prices in energy and other commodity markets that lack CFTC-set position limits. Given the absence of evidence that any speculation has caused aberrant price fluctuations or changes, or that position limits have had any price impact, it is unsurprising that the CFTC's Federal Register Notice does not contain a finding that the proposed position limits are "necessary to prevent" burdensome speculation, as the law contemplates. CEA § 4a(a).

In considering the Commission's position limit proposal, FIA has applied one standard: would the proposed limits help or harm the ability of the U.S. futures markets to serve the public interests in price discovery and efficient price risk management? Based on the available record, FIA must answer that the proposal would actually harm these public interests and should not be adopted. This letter will explain "why."

Summary

Speculation is essential to properly functioning futures markets and therefore serves the public interest as Congress has recognized. Speculators play a vital role in futures trading by assuming the risk hedgers want to avoid and by providing market liquidity which promotes reliable commodity price discovery for businesses world-wide. On the other hand, any market participant, whether a speculator or a hedger, that intentionally creates artificial prices – manipulators – compromises the public interests served by futures markets.

For that reason, many of the Commodity Exchange Act's provisions focus on preventing artificial prices that deplete futures markets of their many public benefits. One of those provisions is Section 4a, the source of the CFTC's position limit authority. CEA § 4a states that "excessive speculation ... causing sudden or unreasonable fluctuations or unwarranted changes in the price" of a traded commodity "is an undue and unnecessary burden on commerce in that commodity." To address that potential burden, in CEA § 4a(a) Congress has authorized, not required, the CFTC to impose position limits on speculators "as the Commission finds are necessary to diminish, eliminate or prevent such burden." Under this authority, if the Commission found that excessive speculation already existed, then it would need to show any position limits it would impose were "necessary to diminish [or] eliminate" that excessive speculation. But if excessive speculation is not found to exist, the CFTC may still impose position limits at a level the Commission finds to be "necessary to prevent" the burden of excessive speculation that might otherwise exist in the future.

This statutory map is vital to navigating the CFTC's Federal Register Notice and its accompanying proposal. In that Notice, the CFTC does not find that energy futures markets have suffered or currently suffer from excessive speculation – that is, speculation "causing sudden or unreasonable fluctuations or unwarranted changes in the price" of any energy commodity. FIA agrees. There is no evidence that speculators have caused or are causing either of the two conditions Congress considered to be a burden on interstate commerce.

Under CEA § 4a(a), the CFTC could still impose limits if it found that its proposed limits are "necessary to prevent" the burdens of excessive speculation in the future. The Commission's Notice, however, disclaims its legal responsibility to make such a finding, asserting that "a specific demonstration of the need for position limits is contrary to section 4a(a) of the Act, which provides that the Commission shall set position limits from time to time, among other things, to prevent excessive speculation." 75 Fed. Reg. at 4146 n.13. The statutory language, however, clearly *requires* a "necessary" finding. The Commission never makes that required statutory finding for its proposal; it never attempts to explain how the proposal is "necessary to prevent" what the CFTC believes to be "sudden or unreasonable price fluctuations or unwarranted price changes" which burden commerce.

This omission creates two legal flaws in the Commission's proposal: one substantive and one procedural. Both confirm that the proposal should not be adopted.

Substantively, in the absence of the "necessary" finding, the CFTC lacks the statutory authority to adopt position limits. The absence of the required "necessary" finding as part of the proposal makes it impossible to determine whether the CFTC would have a rational basis for making such a finding. In modern futures markets, prices fluctuate and change constantly and dynamically. Trying logically to link a certain level of open speculative positions – long and short – to those price fluctuations or changes in order to prevent fluctuations or changes that are "unreasonable" or "unwarranted" may be a difficult task. But that is what the statute requires and the CFTC proposal's silence on this critical legal point precludes its adoption. (See pages 16-17.)

Procedurally, even if the CFTC made the required "necessary" finding in a Federal Register Notice adopting final rules, that finding would be too late to afford meaningful comment on this proposal under the Administrative Procedure Act. Congress allowed the CFTC to impose position limits only when "necessary." If the CFTC finds its proposed limits are "necessary to prevent" the burdens of excessive speculation, the public is entitled to comment on the basis for that finding. The public is not required to guess at the Commission's reasoning. But, here, in the absence of the CFTC's "necessary" finding, guessing is all the public could do. The CFTC does ask the public to comment on whether any limits are necessary. That question is the kind of question the Commission would ask in a three-step rulemaking at the Advanced Notice of Proposed Rulemaking stage, not when it is seeking comment on a specific proposed rule it intends to adopt as its next rulemaking action. This is further evidence that the CFTC should not proceed next to consider whether to adopt its position limit proposal. Public comment is required on how the CFTC "finds" its proposed limits are "necessary" to "prevent" the burdens of excessive speculation. (See pages 13-15.)

Even if the CFTC had accompanied its proposal with the legally-required "necessary" finding, FIA would oppose adoption of this proposal for many reasons.

- The proposals are premature. Congress is considering legislation to amend the Commission's position limit authority. If that legislation is enacted, the CFTC position limit proposals would likely have to be amended as they in many ways conflict with at least the bill passed by the House: H.R. 4173. The CFTC should wait for Congress to act, especially where the CFTC has not found that a burden resulting from excessive speculation exists today. (See pages 11-13.)

- The proposals would harm the public interests in futures trading. The CFTC's proposed new energy position limits will drive considerable trading activity and market liquidity to over-the-counter swap and overseas markets where the CFTC today lacks statutory power to impose limits. That means less liquidity in the open and transparent price discovery markets the CFTC regulates. That means less liquidity to provide efficient price risk management for hedgers. That means more trading activity in markets where the CFTC has no, or at least weaker, market surveillance vision, thereby undermining the CFTC's ability to prevent price manipulation and ensure market integrity. (See pages 13, 28.)

- The CFTC has not stated a rational basis for its proposal. The "excessive concentration" and "uncontrolled speculation" themes the CFTC cites are both factually unproven and legally irrelevant. The statute provides that position limits may be imposed only when the CFTC finds limits would be "necessary" to prevent unreasonable price fluctuations or unwarranted price changes. The CFTC is bound by its statutory authority. (See pages 17-20.)

- FIA believes the Commission has other, more effective means for addressing its market surveillance challenges. Where multiple trading platforms exist for a commodity, the CFTC could adopt its own system of accountability rules to give it a more appropriate means of dealing with its market-wide surveillance concerns. Position limits should be a last resort; they are "necessary" only when other less intrusive means have failed. (See pages 6, 19 and 29.)

- The CFTC's "crowding out" proposal is not "necessary" to prevent excessive speculation and contravenes CEA § 4a(c). By definition, allowing hedgers, including swap dealers, to establish speculative positions below the limits adopted to prevent excessive speculation should not make that speculation excessive in any way. By statute, the CFTC may not transform bona fide hedge positions into speculation because the hedger also engages in some speculation in other trading. The Commission should subject all positions characterized as "speculative" to any adopted limits, and not bar any party otherwise qualifying for an exemption from engaging in permissible levels of speculation. (See pages 21-23.)

- Swap dealers are recognized under the proposed rules to be bona fide hedgers. FIA agrees. Dealers should therefore be treated for purposes of exemptions like all other hedgers. The CFTC has not offered any reason to discriminate against swap dealers through a more restrictive hedge exemption than all other hedgers may receive. (See pages 23-26.)

- The CFTC's aggregation proposal should not be adopted. The CFTC's Notice does not explain why its existing Part 150 account controller aggregation standard would be inadequate for energy commodities. The proposed "ownership" standard would be unworkable for many funds as well as those FCMs that are part of large financial institutions and have decentralized, extensive and liquidity-providing trading operations. Independent account controllers should not have their positions aggregated; when two or more independent traders trade for the same fund or FCM, they can not logically be viewed as a single speculative trading entity that is trading in concert or trying to affect prices in the same way. Likewise, when any entity's trading is independent from that of its affiliates or parent, the entity, its affiliates and its parent, should not be lumped together as a single trader or treated as if they were trading in concert. It distorts economic reality and proper corporate governance to do so. (See pages 26-28.)

Although FIA opposes adoption of the proposals, FIA would support effective CFTC enhancements to its already strong efforts to prevent price manipulation and distortion in energy markets. FIA has long championed a more active CFTC market surveillance effort where multiple trading platforms are competing for market share in the same commodity. The

Commission is right that in these instances no exchange or similar platform is able to see clearly the "whole field" and make fully informed market surveillance judgments solely in the public interest. FIA would support stepped-up CFTC surveillance programs in the energy markets where competing exchanges or other trading platforms are operating.

For example, FIA believes the CFTC should explore the adoption of its own version of position accountability rules, to allow it to monitor better and more directly the trading activities of market participants with significant positions in energy commodity futures or options on more than one trading platform. The CFTC is in the best position to impose these aggregate accountability levels in order to monitor the trading activities of all major market participants, whether hedgers or speculators, and could also use its special call authority to amplify its market surveillance systems for OTC markets, when timely and warranted. In these ways, the Commission could serve the statutory purpose of deterring price manipulation and preserving market integrity without the unintended and adverse consequences we fear would flow out of its energy position limit proposal.

I. SPECULATION AND THE PUBLIC INTEREST

Protecting price discovery and efficient price risk management is at the core of the Commission's mission under the CEA. Speculation plays an essential role in furthering both of these goals. Trading by speculators provides market liquidity which promotes more effective commodity price discovery for businesses and economies world-wide. The dissemination of reliable price benchmarks to producers, consumers, processors and other businesses allows them to use the pricing information to make important commercial decisions. For example, it is reported that attractive futures prices for corn induced farmers to plant new corn acreage and bring it to market. *See* CFTC Staff Report on Cotton Futures and Option Market Activity (Jan. 4, 2010) at 7, *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/cottonfuturesmarketreport0110.pdf.

Speculators also play an important role in futures trading by assuming the price risks that hedgers seek to avoid. As a result, a hedger – such as an oil producer – is able to conduct daily operations or invest in capital improvements to its operations with greater certainty, knowing today the price it can sell at in the future. Without speculators to assume the risk that hedgers wish to avoid, futures market prices would be so volatile and unpredictable that the markets would be unable to serve the public interest in providing efficient risk management and reliable price benchmarks.

Congress itself has found that speculators – as market participants that "assume risks" – are integral to the benefits of futures trading. In Section 3(a) of the Commodity Exchange Act, Congress stated that those who "manag[e] and *assum[e] risks,* discover[] prices, or disseminat[e] pricing information" through trading in "liquid, fair and financially secure trading facilities" serve the national public interest. 7 U.S.C. § 5(a) (emphasis added). Thus, Congress has recognized that speculators contribute to the "national public interest" served by futures trading.

II. HISTORICAL BACKGROUND ON FEDERAL POSITION LIMITS

The Federal Register Notice's historical background on federal position limits, 75 Fed. Reg. at 4145-4148, illustrates the different perspectives on speculative position limits adopted by regulators over the years, both the federally-imposed limits on agricultural commodities and the exchange-imposed limits on all other commodities. A complete understanding of this history would include a number of additional facts.

- When the Commission was created in 1975, it convened an Advisory Committee of experts to assess the efficacy of speculative position limits. As described in Appendix E to the September 2008 CFTC Staff Report on Commodity Swaps Dealers and Index Traders, in the 1975 Advisory Committee's study "serious questions were raised concerning the effectiveness of position limits as a regulatory tool." 2008 Report at 52. Following its review, the 1975 Advisory Committee recommended: "Speculative position limits should not play a major role in the CFTC's future regulatory program. In the long run they should be supplanted by an improved monitoring and surveillance program designed to achieve orderly liquidation of expiring contract months." 2008 Report at 53. A subsequent CFTC staff study concluded, however, that "position limits should be set in some, but not all, markets." 2008 Report at 53 (quoting 1977 CFTC Economists' Study).

- The Commission thereafter decided to continue to impose federal position limits only on certain agricultural commodities. All other position limits for all other commodities were imposed by the exchanges. Those exchange rules were subject to CFTC review and approval prior to 2000. Then, as today, the CFTC could alter or supplement any position limit adopted by any designated contract market under its CEA § 8a(7) authority to alter and supplement DCM rules.

- From 1922 to 2000, federal regulation was premised on a congressional finding that speculation was dangerous and needed to be regulated. The Grain Futures Act of 1922 found that regulation was needed because futures were "susceptible to speculation, manipulation and control" that could lead to "sudden or unreasonable fluctuations in price." Grain Futures Act of 1922, Section 3, 42 Stat. 999 (1922). In 1982, Congress changed that statutory finding to express concern that futures were "susceptible to excessive speculation and can be manipulated, controlled, cornered or squeezed," but dropped the reference to sudden or unreasonable price fluctuations. Futures Trading Act of 1982, 96 Stat.

2298 (Jan. 11, 1983). In 2000, Congress repealed the finding that futures were susceptible to "excessive speculation." Now, as we have seen, Section 3(a) of the CEA recognizes that speculation contributes to allowing the futures markets to serve the national public interest, while Section 3(b) identifies as one of the CEA's purposes the prevention of price manipulation and other disruptions to market integrity.

- In 2000, Congress also left untouched the findings and position limit authority in CEA § 4a. Congress decided not to apply most of the 2000 Act amendments to trading in agricultural commodities because it wanted to retain virtually all of the pre-2000 regulation of agricultural commodities without change. Congress knew that the CFTC had used its authority under Section 4a to impose position limits only on certain agricultural commodities and it logically retained those provisions as part of its overall goal to leave agricultural commodity trading undisturbed.[2]

- In 2000, Congress expressly endorsed the concept of using accountability levels for speculators to protect market integrity. It added statutory Core Principles for DCMs calling for them to "monitor trading to prevent manipulation, price distortion and disruptions of the delivery or cash-settlement process." CEA § 5(d)(4). Congress also provided that "to reduce the potential threat of market manipulation or congestion, especially during trading in the delivery month, the [DCM] shall adopt position limitations or position accountability for speculators, where necessary and appropriate." CEA §§ 5(d)(4) and (5).

- After passage of the 2000 amendments, the CFTC issued Acceptable Practices for implementing these Core Principles, which included the following: 1) position limits may be needed in certain commodities "to address the threat of disorderly liquidations and excessive speculation," 2) position limits are not necessary where the threat of manipulation or excessive speculation is low in futures in commodities with "very liquid and deep underlying cash markets," and 3) "A contract market may provide for position accountability provisions in lieu of position limits for contracts on financial instruments, intangible commodities, or certain tangible commodities. Markets appropriate for position accountability rules include those with large open-interest, high daily trading volumes and liquid

[2] In 2008, Congress did amend CEA § 4a to authorize the CFTC to impose position limits on energy contracts found to be Significant Price Discovery Contracts. Congress did not, however, mandate in any way that the CFTC impose limits on those energy contracts.

cash markets." 17 CFR Part 38 App. B. Among other things, these Practices provided flexibility to DCMs.

- The CFTC thereafter left undisturbed the decisions of DCMs to impose accountability levels for many energy futures markets. Apparently, these DCMs believed these energy commodities had "large open-interest, high daily trading volumes and liquid cash markets." In any event, the CFTC has never found that accountability levels are not effective to prevent excessive speculation.

III. CEA § 4a AUTHORIZES SPECULATIVE POSITION LIMITS

Section 4a of the CEA is the source of the Commission's position limit authority. Section 4a(a) states:

> "Excessive speculation in any commodity under contracts of sale of such commodity for future delivery made on or subject to the rules of contract markets or derivatives transaction execution facilities, or on electronic trading facilities with respect to a significant price discovery contract causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity, is an undue and unnecessary burden on interstate commerce in such commodity. For the purpose of diminishing, eliminating, or preventing such burden, *the Commission shall, from time to time, after due notice and opportunity for hearing, by rule, regulation, or order, proclaim and fix such limits on the amounts of trading which may be done or positions which may be held by any person* under contracts of sale of such commodity for future delivery on or subject to the rules of any contract market or derivatives transaction execution facility, or on an electronic trading facility with respect to a significant price discovery contract, *as the Commission finds are necessary to diminish, eliminate, or prevent such burden*." (emphasis added)

Section 4a also exempts bona fide hedge positions from speculative positions limits and the CEA allows the CFTC to adopt other appropriate exemptions as it sees fit. Section 4a does not extend the CFTC's position limit authority to over-the-counter swap transactions or to futures trading on a foreign board of trade. CFTC position limits imposed under Section 4a(a) are restricted to those futures that are traded on designated contract markets or derivatives transaction execution facilities as well as significant price discovery contracts traded on an electronic trading facility. In 2000 and 2008, Congress also authorized designated contract markets and electronic trading facilities to impose position limits or accountability levels as these self-regulatory bodies determined to be necessary and appropriate.

IV. CEA § 4a DOES NOT MANDATE CFTC-IMPOSED POSITION LIMITS

Much has been made of the word "shall" in the second sentence of Section 4a(a). The argument is made that Congress used the word "shall" to mandate federal-set position limits.[3] The statute's terms and history, as well as the CFTC's own application of its statute, establish that CEA § 4a(a) does not mandate CFTC-imposed position limits.

The statute is clear. The Commission "shall" impose positions limits "as the Commission finds are necessary to diminish, eliminate, or prevent" the burdens of excessive speculation – commodity price fluctuations or changes that are sudden, unreasonable or unwarranted. The Commission's authority to impose position limits (i.e. the "shall") is therefore conditioned on a finding that limits are "necessary." Importantly, the statutory prerequisite requires a finding that the position limits are "necessary" – not just appropriate or helpful – to perform one of three functions: "diminish," "eliminate," *or* "prevent" a burden on interstate commerce resulting from excessive speculation. Thus, where a burden does not already exist (to be diminished or eliminated), Section 4a still requires the Commission to find that speculative position limits are necessary to *prevent* such a burden.

The history also is clear. From 1936 to today, no federal regulator has interpreted Section 4a to mandate federal position limits. In 1938, the Commodity Exchange Commission having conducted evidentiary hearings beginning December 1, 1937, made specific factual findings that certain levels of open net speculative positions "tend to cause sudden and unreasonable fluctuations and changes in the price of [grain] not warranted by changes in the conditions of supply or demand" and then concluded:

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3 For example, CFTC Chairman Gary Gensler stated, "The CFTC is directed in its original 1936 statute to set position limits to protect against the burdens of excessive speculation, including those caused by large concentrated positions. In that law – the Commodity Exchange Act (CEA) – Congress said that the CFTC 'shall' impose limits as necessary to eliminate, diminish or prevent the undue burden that may come as a result of excessive speculation. We are directed by statute to act in this regard to protect the public." *See* 75 Fed Reg. at 4169 (Statement of Chairman Gary Gensler).

> "in order to diminish, elevate, or prevent excessive speculation in grain futures which causes unwarranted price changes, *it is necessary* to establish limits on the amount of speculative trading ... which may be done by any one person."

3 Fed. Reg. 3145, 3148 (Dec. 24, 1938) (emphasis added).

Significantly, the CEC made these limits applicable only to some commodities regulated under the CEA – "wheat, corn, oats, barley, rye, and flaxseed." *Id.* at 3145. Cotton, rice, grain sorghums, mill feeds, butter, eggs and Irish potatoes were not subject to any CEC limits. Thus, contemporaneous with the enactment of CEA § 4a in 1936, the officials charged with administering its provisions did not interpret the "shall" in Section 4a to direct the CEC to impose limits on all regulated commodities.

The Commission's application of CEA § 4a also is clear. The Commission has never interpreted the word "shall" in Section 4a to require the imposition of position limits. Even the current proposal does not apply to all commodities, just energy commodities. But perhaps the best evidence that CEA § 4a does not direct the CFTC to impose anything is the CFTC's decision in 1979 to repeal daily trading limits. From 1936 to today, Section 4a(a) of the CEA expressly has authorized federally-imposed daily trading limits for speculators. For many years, federal regulators imposed such limits. In 1979, the CFTC repealed the daily trading limits finding they were no longer "necessary." 44 Fed. Reg. 7124 (1979). Thus, the Commission itself has interpreted the "shall" in CEA § 4a to be secondary to the finding of necessity the agency must make before imposing any speculative limits.

V. THE PROPOSAL IS PREMATURE AND PROCEDURALLY FLAWED

FIA urges the Commission not to adopt its proposal for prudential and procedural reasons. First, until Congress has finished its work this session on legislation to amend the CFTC's position limit authority, it is premature for the Commission to adopt final position limit rules. Second, the Commission has not complied with the Administrative Procedure Act's mandate that the public be afforded an opportunity for meaningful comment on important aspects of the proposal, specifically the finding the Commission must make that its proposal is "necessary to prevent" excessive speculation resulting in a burden on interstate commerce.

A. Premature in Light of Legislation.

On December 11, 2009, the U.S. House of Representatives passed H.R. 4173. Section 3113 of that legislation contains ten pages of substantive amendments to Section 4a of the Commodity Exchange Act. The scope and significance of these amendments demonstrate why it would be premature for the Commission to adopt its position limit proposal. The amendments would extend the Commission's position limit setting authority in physical commodities to certain swaps, both those that are economically equivalent to futures and those found to be significant price discovery swaps (authority the CFTC would be required to exercise concurrently). The CFTC also would obtain authority to impose position limits on U.S. traders with direct access to trading in futures contracts listed on foreign boards of trade (FBOTs) when those foreign contracts are linked through settlement prices to U.S. traded contracts. Section 3113 would also revise the process and relevant factors by which the CFTC sets limits. It would empower the CFTC to impose aggregate, commodity-wide limits on futures, swaps and FBOT futures. Section 3113 would also amend the Commission's authority to establish exemptions for bona fide hedging and swap dealing activity. It is unclear, in fact, whether the criteria for the CFTC's proposed risk management exemption for swap dealers would even be compatible with the limitations Section 3113 would impose.

Even so, the CFTC's proposed risk management exemption for dealers perfectly illustrates why the CFTC should defer action for now. Under Section 3113, the CFTC must adopt simultaneously position limits in energy commodities for futures and economically equivalent swaps. Those limits would make the dealer risk management exemption largely irrelevant in many circumstances because dealers that use futures to offset their price risk from their swap positions (in short to hedge) should not exceed, or even approach, any reasonable speculative position limit the CFTC would set.

An example may be helpful. Assume Section 3113 is enacted and the CFTC sets a limit of 1000 contracts for both crude oil futures and swaps. A swap dealer and its counterparty enter into a swap with a notional amount equal to 2000 contracts; the dealer is long the equivalent of 2000 futures contracts. The dealer then enters into a short futures position to hedge that risk of 2000 contracts. The next day the dealer adds one short speculative contract to its position. Under Section 3113, the dealer should be found at that point to have a net one short position; it is well within the position limit and would not need an exemption. In contrast, under the CFTC's proposal, the swap positions are not included (and cannot be netted). Therefore the dealer – for the same conduct – would be found to violate the CEA because its futures position exceeds the 2000 contract limit on risk management exempt positions. (In fact, under the proposal, the one short speculative position also would cause the dealer to lose its risk management exemption; the dealer would then be 1001 contracts over the CFTC's speculative position limit.) It would be odd if the CFTC were to adopt a proposal that would make a swap dealer potentially guilty of a criminal felony for violating the terms of CFTC position limits when Congress may act soon to make the **same conduct** perfectly legal.

Moreover, if the CFTC adopts its proposals and then proposes and adopts a second set of position limit rules after the reform legislation is enacted, it will increase costs for the CFTC, futures commission merchants and market participants alike. Many of these costs will be operational and administrative as FCMs and market participants build systems to take into account the CFTC's new rules. Those substantial costs would be avoided if the Commission waited a few months for Congress to finish its deliberations and then addressed position limits under any new authority the CFTC might receive.

FIA agrees with some and disagrees with many of the statutory changes in the House bill's Section 3113. We also know that no one knows whether Congress will enact financial regulatory reform legislation generally or any position limit amendments specifically. But there is no doubt that the CFTC's position limit authority is the subject of active congressional consideration at this time. Until those deliberations are resolved, at least for this session of Congress, FIA believes it would be prudent for the CFTC to refrain from acting on its proposal for position limits for energy commodities.

Most importantly, deferring action would be consistent with the public interest. As Section 3113 makes clear, swaps and foreign futures are offered now on many energy commodities. None of those transactions would be subject to the CFTC's proposed limits. Some of those transactions – foreign futures contracts entered into by foreign entities – could never be subject to the CFTC's proposed limits, even if the provisions of Section 3113 are enacted. Some market participants likely will want price exposures beyond those allowed by the proposed limits, or will want to avoid the legal uncertainty and regulatory compliance costs the proposals will surely cause. Those traders can reasonably be expected to move their activities to the swap or FBOT platforms. This shift in market liquidity will harm the public interest in price discovery and efficient risk management. It will also compromise the ability of the Commission itself to conduct market surveillance and could thwart CFTC efforts to serve one of the major purposes of the CEA – to prevent price manipulation and preserve market integrity.[4]

These arguments are not original. A number of members of the Commission have expressed similar concerns. FIA believes those Commissioners are right to be concerned. If the Commission had found that excessive speculation has existed or now exists in the market, FIA would understand the CFTC's need to move quickly. But the Commission has not found excessive speculation to exist now. There is no pressing, urgent need for these proposals. The Commission should not move forward to adopt them at least until the end of Congress's deliberations.

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4 Swaps and foreign futures contracts are not the only means available to those who seek price exposure to energy commodities. As the Commission's hearings last summer revealed, well-capitalized parties, both foreign and domestic, could buy and hold physical inventories as a means of obtaining price exposure without regard to CFTC-imposed position limits. The Commission does not take into account this phenomenon as a possible consequence of its proposal.

B. Failure to Allow Meaningful Comment.

The Commission should not proceed next to consider adopting its energy limits proposal because it has not afforded the public an opportunity to meaningfully comment on the proposal under the Administrative Procedure Act (APA). The APA requires that "notice of a proposed rule . . . include sufficient detail on its content and basis in law and evidence to allow for meaningful and informed comment." *See Amer. Med. Ass'n v. Reno*, 57 F.3d 1129, 1132 (D.C. Cir. 1995) (interpreting the APA's requirements in 5 U.S.C. § 553(b,c)). In *American Medical Association*, the Drug Enforcement Agency (DEA) had issued a notice of proposed rulemaking to increase controlled substance registration fees based on its statutory authority to set fees "at a level that ensures the recovery of the full costs of operating the various aspects of [the diversion control] program." The D.C. Circuit found that the DEA's notice did not provide a meaningful opportunity for comment because it failed to explain how the increase in fees would ensure the recovery of the program's operating costs. *See id.* at 1130-33.[5]

Like the DEA's notice in *American Medical Association*, the CFTC's Notice lacks the required basis for its proposed rules. That is, the CFTC has not explained why it thinks the proposed speculative position limits would be "necessary" to "prevent" a "burden on interstate commerce" resulting from excessive speculation. The CFTC does not make the required "necessary" finding in its notice because, in our view, it misreads the statute to say that finding is not necessary. *See* 75 Fed. Reg. at 4146 n.13 (Jan. 26, 2010). But, without being given a basis for the proposed rules, the public can not comment on the Commission's reasoning for its proposal. As *American Medical Association* made clear, "meaningful" public comment is rendered impossible in such a situation.

In the past, the CFTC and its predecessor have complied with the meaningful comment mandate by explaining the basis for the "necessary" finding in CEA § 4a. This is exactly what

[5] This rule of administrative law has been applied in many cases. *See, e.g.*, *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).

the Commodity Exchange Commission did in 1938 when it implemented Section 4a for the first time. In 1938, the CEC issued a proposed order to impose position and daily trading limits in grain futures. In that notice, the CEC made explicit that establishing the proposed limits was "necessary" to "diminish, eliminate, or prevent the undue burden of excessive speculation in grain futures which causes unwarranted price changes" and invited public comment on its basis for that finding. 3 Fed. Reg. at 1409 (June 11, 1938). The CFTC itself followed the same practice in 1978 when it proposed to repeal daily trading limits under Section 4a. Before acting, the CFTC offered its basis for the proposed statutory finding that daily trading limits were no longer "necessary" or "required" and requested public comment on its proposed finding. 43 Fed. Reg. at 43034 (Sept. 22, 1978).

In each case under Section 4a, the agency explained why its proposed limits were "necessary" or not "necessary" and asked for public comment on its reasoning. Then the agency proceeded to final action on its proposal. In this proposal, however, the Commission deviated from its prior practice and eschewed taking the first required step. Therefore, the CFTC should not take the second step and approve the proposed rules.

In this regard, the Notice actually treats the issue of whether limits are "necessary" as if the CFTC was conducting a three-stage rulemaking process and had begun that process with an Advanced Notice of Proposed Rulemaking.[6] In the Notice, the Commission asks the public for comment on the generic question of whether any speculative position limits are "necessary." That question is the kind of question the Commission usually poses in a three-step rulemaking at the Advanced Notice of Proposed Rulemaking stage, when the Commission requests information needed to develop a proposed rule. For example, in a 1986 Advance Notice of Proposed Rulemaking, the Commission asked the public the very similar question of whether revisions to speculative position limits on agricultural commodities were "necessary." 51 Fed. Reg. at 31649 (Sept. 4, 1986).

Ultimately, what the Commission has done here – asking for public comment on whether limits generally are necessary without explaining why it finds the proposed limits to be "necessary" – is what the Commission typically does at the Advance Notice of Proposed Rulemaking stage, **not** the Notice of Proposed Rulemaking stage. Consistent with the APA and its own practice, the Commission should not proceed next to consider whether to adopt its position limit proposal.

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6 FIA has attached to this comment letter our answers to the 17 specific questions the CFTC poses in its Federal Register Notice.

VI. THE PROPOSAL CONTRAVENES THE CEA AND HAS NO RATIONAL BASIS

Even if the Commission's proposal was not premature and had afforded the public a meaningful opportunity for comment, it should not be adopted. The proposal is contrary to the CEA and is not rationally related to preventing excessive speculation as defined by law. The proposal's restrictive exemptions compound these infirmities and are incompatible with the CEA. The proposed departure from the existing Part 150 aggregation standards is unjustified. The costs of the proposal also greatly exceed any cited benefits. The Commission has better alternatives available to enhance its market surveillance efforts and should pursue those enhancements, not this proposal.

A. No Statutorily-Required "Necessary to Prevent" Finding.

The Commission's Federal Register Notice does not find that excessive speculation has created a burden on interstate commerce as contemplated by CEA § 4a. The Commission therefore does not find that position limits are necessary to "diminish" or "eliminate" an extant burden. FIA agrees that the record does not support a finding that excessive speculation is causing unreasonable price fluctuations or changes that have resulted in a burden on interstate commerce. Instead, the available evidence – including the CFTC's own data and analysis – support the conclusion that market fundamentals drove the 2008 price spikes in various commodities.[7]

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7 The CFTC's own research indicates that the rise in oil prices was largely attributable to supply and demand factors. *See* Commodity Futures Trading Commission, Commodity Swap Dealers & Index Traders with Commission Recommendations (Sept. 11, 2008), *available at* http://www.cftc.gov/stellent/groups/public/@newsroom/documents/file/cftcstaffreportonswapdealers09.pdf); *see also* Interagency Task Force on Commodity Markets, Interim Report on Crude Oil (July 22, 2008) at 3-4, *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/itfinterimreportoncrudeoil0708.pdf (concluding that large or rapid movements in oil prices are consistent with the fundamentals of supply and demand); U.S. Government Accountability Office, Issues Involving the Use of the Futures Markets to Invest in Commodity Indexes (Jan. 30, 2009) at 5, *available at* http://www.gao.gov/new.items/d09285r.pdf (concluding that the eight empirical studies reviewed "generally found limited statistical evidence of a causal relationship between speculation in the futures markets and changes in commodity prices – regardless of whether the studies focused on index traders, specifically, or speculators, generally"). Testimony during the CFTC's energy hearings further confirms that price spikes were not caused by speculators. For example, Professor Philip Verleger, Jr. (Haskayne School of Management, University of Calgary, PK Verleger LLC) testified that, "The increase in crude oil prices between 2007 and 2008 was caused by the incompatibility of environmental regulations with the then-current global crude supply. *See* FIA Supplement to Comment Letter re Commission's "Concept Release on Bona Fide Hedge Exemption" (Aug. 12, 2009) at 1 (restating Verleger's testimony). A survey of a significant cross-section of economists also revealed that, "The global surge in food and energy prices is being driven primarily by fundamental market conditions, rather than an investment bubble

(Footnote Continued...)

FIA also agrees that the CFTC does not have to make a finding that its limits are necessary to "diminish" or "eliminate" extant burdensome excessive speculation in order to exercise its position limit authority. However, FIA does not agree with the Commission's statement that demonstrating any "need" for the proposed position limits "is contrary to section 4a(a) of the Act." *See* 75 Fed. Reg. at 4146 n.13. Section 4a(a) expressly requires the Commission to find that its position limits are "necessary" to perform <u>at least one</u> of three functions: "diminish, eliminate, or prevent" the burdens of excessive speculation. Thus, where no burden exists to be diminished or eliminated, the Commission is still required to find that its limits are "necessary" to "prevent" the burden of excessive speculation that may someday exist.

The Commission does not make that finding. The Commission also has not shown that key aspects of its proposed framework are "necessary" – namely, adopting "crowding out" rules that would treat hedgers' hedges as speculation and abandoning the independent controller rules for aggregation. Without these findings, the Commission cannot impose its proposed position limits on energy contracts in compliance with CEA § 4a(a).

B. No Rational Basis for Proposed Limits.

The CFTC has not stated a rational foundation for its proposal. The extra-statutory justifications offered by the CFTC are overbroad extrapolations of unsupportable concerns relating to speculative position concentrations generally. The Commission's reliance on its experience with position limits on agricultural commodities is also misplaced.

1. The Proposal's "Excessive Concentration" Focus is Misguided.

The CEA allows for federal position limits to prevent excessive speculation, not position concentrations. It does not provide the CFTC with explicit authority to decide on the proper allocation of net "long" or "short" market share. Nevertheless, and in lieu of the statutorily required "necessary to prevent" finding, the Commission argues that its proposed energy

(Footnote Continued)

[caused by speculators on the buy side]." *See* Phil Izzo, Bubble Isn't Big Factor in Inflation, WALL ST. J., May 9, 2008, at A2. Paul Krugman, New York Times columnist and Professor of Economics at Princeton University, has written extensively on the cause of the energy price spikes and also concludes that they were not driven by speculators. *See e.g,* The Oil Nonbubble, N.Y. TIMES, May 12, 2008, *available at* http://www.nytimes.com/2008/05/12/opinion/12krugman.html ("[T]he rise in oil prices isn't the result of runaway speculation; it's the result of growing difficulty of finding oil and the rapid growth of emerging economies like China.").

commodity position limits would "further" the objective of preventing harms that might arise from concentrations of large speculative positions. According to the Commission, "the potential exists" that "large speculative positions" could result in "unreasonable and abrupt price movements" should "the positions be traded out of or liquidated in a disorderly manner." 75 Fed. Reg. at 4149.

In addition to falling far short of what the statute requires, the problem with the CFTC's argument is that it does not describe any harm that is unique to concentrations of speculative positions, and might be addressed by limits on speculative positions. "Unreasonable and abrupt price movements" would seem to result from the "disorderly" liquidation of concentrations of *any* large positions, regardless of their characterization as speculation or not. The Commission itself seems to acknowledge this flaw in its logic by sometimes stating that concentrations of large positions in general – as opposed to large speculative positions in particular – can cause abrupt price changes.[8]

In any event, experience teaches that the disorderly liquidation concern is one that is most acute in the delivery month. Exchanges and the Commission already are armed with a well-equipped tool box of systems and methods to prevent disorderly liquidations. Those tools have worked well, which is not surprising as Congress made disorderly liquidation prevention the focal point of a Core Principle for designated contract markets as well as specific emergency actions Congress has authorized the CFTC and exchanges to take. CEA §§ 5(d)(4) and (6) and 8a(9). Nor is there any proof or even a suggestion in the Commission's Federal Register Notice that disorderly liquidations in the deferred months have plagued or present a realistic threat to energy commodity pricing.

Without showing how concentrations of speculative positions are more harmful and have a greater impact on price than concentrations of other positions, the Commission cannot assert that the proposed limits on speculation are "necessary" to prevent the alleged harms arising from speculative position concentrations. Those perceived harms would occur despite the limits on speculative positions if concentrations of other large positions were reduced or liquidated in a

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8 *See, e.g.*, 75 Fed. Reg. at 4162 (Request for Comment, Question 1): "Are Federal speculative position limits for energy contracts traded on reporting markets necessary to "diminish, eliminate, or prevent" the burdens on interstate commerce that may result from *position concentrations* in such contracts?") (emphasis added); *Id.* at 4162 ("Central to these responsibilities is our duty to protect the public from the undue burden of excessive speculation that may arise, including those from *concentrations* in the market place.") (emphasis added); *Id.* at 4163 ("Large *concentrated positions* in the energy futures and options markets can potentially facilitate abrupt price movements and price distortions.") (emphasis added).

disorderly manner. Thus, the Commission has no basis for linking speculative limits to the prevention of deferred month disorderly liquidations of excessively concentrated positions.

2. The Proposal Bans Non-Excessive Concentrations.

Even if the Commission had shown that concentrations of speculative positions are more prone to causing unreasonable price changes than concentrations of large positions in general, the Commission's proposed limits are not rationally designed to prevent *excessive* concentrations. A hypothetical illustrates this point. Assume that the speculative position limit is 2500 (based on a prior year's open interest of 25,000 contracts) and there are 19 speculators on the long side, 18 of which hold 1250 positions and 1 of which holds 2499 positions. If the speculator with 2499 contracts decides the next day to establish two more long positions, it would exceed the speculative position limit. However, no one could seriously maintain that the two additional long positions in any meaningful way create "excessive" concentration on the long side of the market in this scenario. Thus, even if limiting concentrations of speculative positions was statutorily relevant under CEA § 4a and was sound policy, the Commission's proposal overshoots the mark; it would ban activity that cannot rationally be viewed to have any impact on concentration.

As this example shows, a position limit formula based on last year's open interest does not measure accurately the level of concentration in a market today. No formula is an appropriate substitute for an informed market surveillance judgment that market participants have an "excessively concentrated" position in a market. In fact, as the example demonstrates, the proposed formula seems destined to result in many "false positives" which will reduce positions and market liquidity even when no threat of excessive concentration exists.

FIA agrees that position concentrations should be of market surveillance concern to the Commission and the exchanges. Our position is that the blunt instrument of position limits is not suitable in dynamic, ever-changing energy markets to address across-the-board the threat to market prices that concentrations may pose in certain limited circumstances. As an alternative, FIA strongly recommends the surgical tools of aggressive accountability levels and vigilant market surveillance to address excessive concentrations. Through these tools, the CFTC could respond quickly to what it perceives to be emerging threats to the integrity of the price discovery process. It could issue special calls for information in special market circumstances to complement its existing large trader reporting system. When appropriate, these special calls could be issued intra-month, in the periods between the monthly regular special calls the CFTC has instituted. Based on this information and its aggregate accountability levels, the Commission could monitor position concentrations effectively and prevail upon market participants to reduce positions when necessary. Importantly, these measures to strengthen market surveillance all could be taken now by the Commission without waiting for any congressional action and without the adverse impact on market liquidity and price discovery that will inevitably follow from over-broad speculative position limits as the Commission has proposed.

3. The CFTC Has Not Shown That Position Limits Result in More Fair and Reliable Prices.

In lieu of finding that the federal energy position limits would be "necessary" to prevent burdensome excessive speculation, the Commission cannot simply point to its history of setting agricultural position limits to justify its proposed energy limits. In other words, its history with agricultural limits does not authorize it to circumvent or disregard the preconditions Congress has placed on its position limit authority. CEA § 4a still requires that position limits on any commodity, including energy commodities, have their own independent statutory basis – i.e. a finding that the limits are "necessary" to prevent burdensome excessive speculation.[9]

Importantly, the CFTC's Notice does not make the case that the proposed position limits would even be helpful or appropriate (let alone necessary) because the agricultural markets with CFTC-imposed hard position limits have generated better or more accurate prices (or more orderly liquidations) than markets that rely primarily on accountability levels. FIA respectfully submits that the CFTC would be hard pressed to make that case. We have seen no evidence that price limits have helped price discovery in any futures contract. Conversely, we have seen no evidence that accountability levels have not worked to improve market surveillance or promote reliable price discovery and orderly liquidations.

To the contrary, FIA agrees with Commissioner O'Malia's observation that the CFTC's agricultural limits did not cause agricultural market prices to behave in a manner very different from energy markets. 75 Fed. Reg. at 4172. That evidence would surely be dispositive if the CFTC asserted that it must apply its agricultural limit approach to energy markets to diminish or eliminate existing excessive speculation. If the markets with, and the markets without, limits followed similar price trends, it is hard to see how limits would have made any difference in energy prices. To the extent the Commission is arguing that its proposed limits would *prevent* future energy price distortions, the evidence of the apparent past impact (or lack of impact) position limits have had on agricultural market prices is still quite relevant. As Commissioner O'Malia points out, this experience surely heightens the burden on the Commission to

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9 The agricultural and energy markets are not twins. Limits that may be necessary for agricultural commodities are not automatically necessary for energy commodities. In fact, the high seasonality of production and the highly variable nature of old-crop inventory carry-over for agriculture can significantly affect the susceptibility of some agricultural markets to price manipulation or price distortions. These conditions are not generally present in the more continuously-produced and worldwide fungibility of many energy markets.

demonstrate that applying the proposed position limits to energy markets is likely to have a different result. The Commission has not met that burden.

C. Proposed Exemptions Are Unworkable and in Conflict with the CEA.

The Commission proposes to allow two kinds of market participants to exceed the energy position limits: bona fide hedgers qualifying as swap dealers that offset risks associated with swap agreements and all other bona fide hedgers. Both exemptions deviate from the Part 150 exemptions the CFTC has provided for agricultural position limits. The CFTC has not articulated any compelling reason to support its apparent decision to abandon its Part 150 exemptions for energy limits. Nor has it offered any justification for saddling market participants and their futures commission merchants with the considerable compliance cost of maintaining different operational systems for meeting different position limit exemption standards. Most importantly, the CFTC's proposed exemptions do not comply with the CEA. The statute bars the Commission from treating bona fide hedge positions as speculative positions. Therefore the proposal's so-called crowding out restrictions are incompatible with the statute and must be abandoned.

1. All Bona Fide Hedgers Should Be Allowed to Speculate Up to the Speculative Position Limit.

As a matter of logic and consistency, if the Commission believes its agricultural position limit experience is a relevant model for the energy position limit regime, then it should also apply the Part 150 agricultural limit exemptions to its energy regime. Under the agricultural framework, those qualifying for a bona fide hedge exemption can hold speculative positions up to the speculative position limit and still enter into hedge transactions up to the limit set for their hedge exemption. Thus, if the speculative limit is 1000 contracts and a bona fide hedger holds 1500 hedge positions (pursuant to an exemption allowing the hedger to hold up to 2000 hedging positions), the hedger could still speculate independently of its hedge up to the 1000 speculative position limit. In short, in our example, an agricultural hedger could hold 1000 speculative positions *in addition to* its 1500 hedging positions.

However, under the bona fide hedge exemption from the energy position limits, a bona fide hedger would violate the speculative position limit if it engages in any speculation (even one contract) and the combination of its hedging positions and speculative position(s) exceeds the speculative position limit. For example, assume that the energy speculative position limit is 1000 contracts and a bona fide hedger holds 1000 hedging positions (pursuant to an exemption that allows him to hold up to 2000 hedging positions). The bona fide hedger then enters into one speculative contract, for a total of 1001 positions. Under the Commission's "crowding out" proposal, the hedger has violated the speculative position limit. Remarkably, under the CFTC proposal, the Commission would interpret the hedger's one speculative contract to constitute excessive speculation.

As the Commission well knows, it is difficult in every instance to apply with certainty the legal borders of speculation and hedging. Some blurring is inevitable. Hedge positions entered into in good faith can become speculative even without any action by the hedger. (A farmer's hedge position based on an over-projection of crop size could be considered to be speculation, in part.) U.S. Treasury Secretary Timothy F. Geithner made this very point on March 26, 2009 when he testified in Congress: "It's too hard to distinguish what is a legitimate hedge that has some economic value from what people might just feel is a speculative bet on some future outcome." The Need for Comprehensive Regulatory Reform: Hearing Before H. Fin. Servs. Comm. 111th Cong. (2009) (statement of Timothy F. Geithner, Treasury Sec'y of the United States).

This well-accepted legal uncertainty makes the "crowding out" rule even more dangerous. Legitimate market participants may leave the futures markets because they will not accept the legal risk of violating CFTC position limits due to the crowding out proposal, and the possible attendant civil and criminal consequences. If that occurs, futures market liquidity, price discovery and efficient risk management will surely suffer.

Even if the CFTC disagrees with these policy arguments, it should not adopt the "crowding out" rule because it violates the CEA in two ways. First, the proposal violates Section 4a(c) by applying the CFTC's speculative position limit to a hedger's bona fide hedge positions if the hedger also holds any speculative positions. Section 4a(c) of the CEA precludes this result. It clearly states that, "No, rule, regulation, or order issued under subsection (a) of this section shall apply to transactions or positions which are shown to be bona fide hedging transactions or positions . . . ." In effect, CEA § 4a(c) grants a hedger an automatic exemption from the speculative position limit for all positions shown to be bona fide hedging positions. The Commission's proposal to count a hedger's bona fide hedging positions against the speculative position limit where that hedger holds at least one speculative position is thus inconsistent with CEA § 4a(c).

Consider again the example from the beginning of this section. Under the proposal, with a speculative limit of 1000 contracts, a party with a bona fide hedge position of 1200 contracts (under at 2000 position hedge exemption) that enters into one speculative contract, trips the CFTC-set speculative limit. That result conflicts with CEA §4a(c) because it would allow the one speculative contract to transform the 1200 bona fide hedge contracts into speculative positions subject to the proposed limits. By statute, however, speculative limits may not be imposed on hedge positions. The CFTC's proposal thereby contradicts directly the statute's terms.[10]

Second, the Commission's proposal exceeds the CFTC's legal authority under Section 4a(a) by prohibiting speculation that would not be "excessive." In Section 4a(a), Congress recognized that *excessive* speculation – not de minimis or moderate speculation – could create a burden on interstate commerce if it caused unreasonable or unwarranted price changes. As shown above, the Commission's proposal would not be addressing the excessive speculation with which Congress was concerned, but would ban a long hedger with hedge positions up to the speculative position limit from holding even one net long speculative position. The Commission nowhere explains how a hedger's establishment of speculative positions well under (or even up to) the speculative limit would amount to "excessive" speculation. In addition, without finding that its "crowding out" proposal is necessary to prevent the burdens of "excessive" speculation, the Commission cannot sustain this aspect of its proposal under CEA § 4a(a).

The Commission's "crowding out" proposal is ill-advised and inconsistent with CEA § 4a. Rather than adopt this aspect of its proposal, the Commission should follow its Part 150 approach by subjecting all positions characterized as speculative – and only those positions – to the adopted limits on speculation.

2. Swap Dealers Should Be Treated Like All Other Bona Fide Hedgers.

Proposed new Section 151.3(a)(1) of the Commission's regulations provides: "positions that are held to offset risks associated with swap agreements under paragraph (a)(2) of this section" are bona fide hedge transactions to which special exemption criteria apply. Proposed new Section 151.3(a)(2) provides those criteria and grants an exemption from the proposed energy position limits for qualified swap dealers that are using futures markets "outside of the spot month" "to offset risks associated with swap agreements entered into to accommodate swap customers and are either directly linked to the referenced energy contracts or the fluctuations in the value of the swap agreements are substantially related to the fluctuations in value of the referenced energy contracts." The dealer exemption is set at twice the all-months combined or

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[10] The statutory mandate to exempt hedge positions from position limits is solid evidence that Congress did not intend the speculative position limit authority in CEA §4a to be focused on preventing excessive concentrations. Congress knew that some hedgers would maintain some level of speculative trading and determined that was a permissible outcome so long as the speculative trading did not exceed the speculative limit. By its terms excluding hedge positions from limits, CEA §4a(c) rebuts the argument that position limits are supposed to focus on excessive concentrations.

non-spot single month limits, as applicable. The Commission also proposes to impose its crowding out restrictions on dealers in a manner that is similar to all other bona fide hedgers.

The dealer exemption suffers from the same deficiencies as the exemption for other bona fide hedgers, and more. The CFTC has deviated from its Part 150 policy for dealers for no stated reason. The Commission would render the dealer exemption unworkable by precluding dealers from maintaining or establishing speculative positions while relying on the dealer exemption to establish positions at or above the speculative position limit.[11] The proposed crowding out feature runs afoul of CEA § 4a(c) by nullifying the hedge exemption for dealer positions and CEA §4a(a) by refusing to allow dealers to hold speculative positions up to the required limit even though the CFTC offers no basis for concluding that the combined risk management and speculative positions of the dealer constitute excessive speculation under the law.

The dealer exemption is ill-advised on additional grounds. The CFTC cites no basis to treat swap dealers any differently than other bona fide hedgers. Swap dealers use futures to offset price risk and the CFTC agrees that dealers are hedgers. Yet, the CFTC would, for no stated reason, bar swap dealers from holding hedge positions in the spot month, unlike all other hedgers. FIA can not think of any justification for treating swap dealers and other hedgers differently in this way.[12]

Moreover, while other bona fide hedgers may exceed the speculative position limit by an undetermined amount depending on their demonstration of need to the reporting market, the dealer exemption is limited to an absolute cap of twice the speculative position limit. The

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[11] Dealers may be even more susceptible to adverse unintended consequences than other hedgers. If a dealer's swap counterparty reduces the size of its swap position, the dealer will often, for a time, assume that market risk as a speculator until the futures position has been rebalanced with the swap exposure. For example, a dealer might not liquidate its futures position immediately to equal the reduction in the size of its swap position with a counterparty because to do so automatically without concern for the then extant liquidity could result in a pattern of trading in the futures market that could be considered to be disorderly. This concern is particularly relevant when the swap counterparty is based overseas and the agreement to reduce the swap position may occur at a time when the relevant futures exchange is either not open for trading or has limited liquidity during overnight trading hours. In these situations, by the time the dealer rebalances its futures position with the swap exposure, the dealer would have lost its risk management exemption under the proposal and could be in violation of the position limit.

[12] FIA is concerned that excluding dealers from trading at all in the spot month could adversely affect market liquidity and increase price volatility in the delivery month. This concern may well be heightened during the last three trading days because of the inter-relationship of the proposal's physical delivery and cash settlement trading limits.

Commission provides no rationale for its decision to discriminate against swap dealer bona fide hedges in this manner. But dealers need to be treated like other hedgers. Dealers may be hedging long term swap transactions of, for example, 5 years or longer. The proposal calls for the position limit to change annually. If the CFTC-imposed position limit shrinks during one year of the dealer's multi-year hedge it could cause a dealer to now have a speculative futures position, and therefore a limit violation, without any action on the part of the dealer.[13]

If a dealer can prove to a reporting market or the Commission that it needs three times or more the speculative limit to offset the risk on its swap book, there is no reason not to allow the dealer to hedge its market risk on the futures market. In fact, there is good reason to allow it. The dealer will be bringing liquidity to open and transparent trading markets thereby contributing to price discovery and the ability of hedgers to effectively manage their risk. Imposing an artificial hard cap on the size of market risk that a dealer may hedge using futures could simply lead to more risk being held outside the CFTC regulated markets with their attendant counterparty credit risk protections. It is difficult to reconcile that result with the public interest.

Proposed Rule § 151.3(a)(1)(ii), 75 Fed. Reg. at 4169, recognizes that swap dealers may themselves, or through affiliates, also use futures markets to hedge physical energy transaction price risk. However, the proposed rule is unclear regarding whether a dealer may enter into physical hedge positions without having those physical hedges count against the two times position limit cap on swap dealer risk management positions. What is clear under the proposed rule, however, is that where a dealer uses the futures markets to hedge its physical energy transaction price risk under a general bona fide hedging exemption equal to or exceeding twice the speculative position limit, the dealer may not hold or control any positions pursuant to the risk management exemption. (Proposed Rule § 151.3(a)(1)(ii), 75 Fed. Reg. at 4169.) Thus, to the extent that a dealer that wishes to remain as a market maker in the swap markets also wishes

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13 Suppose the CFTC sets the position limit at 1000 contracts. A dealer enters into a 5-year swap with a notional amount equal to 2000 futures contracts. The dealer then enters into an offsetting futures position to hedge that swap risk. In year two of the hedge, the CFTC-set limit is reduced to 900 contracts because of lower open interest in the prior trading year. The dealer's hedge exemption falls to 1800 contracts. The dealer's futures hedge is now larger than the CFTC-imposed 1800 contract limit for dealers. The dealer is in violation even though it didn't change its futures position at all. A variation of this scenario illustrates a similar problem. If during the 5-year swap, the dealer enters into a new swap with a new counterparty that would reduce its market exposure on its original swap from 2000 contracts to 1600 contracts before the dealer is able to reduce its futures position correspondingly, the dealer's futures hedge position would automatically become, in part, a speculative position and would automatically disqualify the dealer from the risk management exemption. The dealer would therefore be in violation of the CFTC-set position limit.

to use futures to hedge its physical energy transaction price risk, the proposal would have the effect of disqualifying or unduly limiting this bona fide hedging activity from being treated as a separate hedge for position limit purposes. This aspect of the proposal conflicts with CEA §§ 4a(a) and (c). As stated above, Congress foreclosed the CFTC from subjecting bona fide hedge transactions to speculative position limits, regardless of the identity of the hedger or its affiliates.[14]

In addition to its legal flaws, the proposal's dealer exemption restrictions fail to account for the different levels of hedging activities in the futures markets and the breadth of activities engaged in by dealers and their affiliates. Using futures to offset or manage price risks created by swap transactions or physical transactions serves the national public interest, as Congress has found (CEA § 3(a)), whether or not both types of hedge transactions were entered into by a dealer itself or its affiliates. If the Commission maintains a separate exemption for dealer risk management activities, the Commission should amend its proposal to allow a dealer that meets the qualifications for both the general bona fide hedging exemption and the dealer exemption to apply for and obtain both exemptions, without allowing one exemption to restrict the level of permissible activity under the other exemption.

D. CFTC Part 150 Aggregation Standards Should Be Applied to Energy Commodities.

The Commission's aggregation proposal for energy contracts is a major departure from longstanding CFTC policy and practice and should not be adopted. It aggregates all positions held in accounts subject to common ownership (based on a 10% or more direct or indirect ownership standard) even where trading for these accounts is independently controlled. However, an "independent account controller" aggregation exemption has been and is currently available for "eligible entities" dealing in *agricultural commodities* and for good reason – when two traders who are completely independent trade for the same corporate entity they cannot be viewed in any way as trading in concert or trying to affect prices in the same way. *See* CFTC

14 An example may make this easier to understand. Assume a position limit of 1000 contracts. Proposed Rule 151.3(a)(1)(ii) states that if Dealer enters into a physical futures hedge of 2000 contracts (or more), Dealer may not qualify for the swap risk management exemption in Proposed Rule 151.3(a)(2). In effect, the proposal thereby would treat any of Dealer's futures positions that offset swap risk as well as its physical hedges as if they were speculative positions. That contradicts CEA § 4a(c). What if Dealer enters into a physical hedge of only 1500 contracts? The proposal is clear that Dealer may put on some futures positions to offset the risk of its swaps. But the proposal is unclear whether Dealer is free to invoke Proposed Rule 151.3(a)(2) up to double the speculative limit (2000 contracts) or only up to 500 contracts. In either case, the proposal's imposition of an artificial cap on Dealer's risk management activity is problematic from both a legal and practical standpoint.

Regulation §§ 150.1(e) and 150.4. The CFTC cites no problems with its existing standard. Thus, there is no reason for aggregating the positions of those independent account controllers.[15]

As an explanation for its decision to depart from Part 150, the Commission states that the proposal calls for high limits on energy positions and the traditional Commission "eligible entity exemption that would allow traders to establish a series of positions each near a proposed outer bound position limit without aggregation, may not be appropriate." 75 Fed. Reg. at 4161. The Commission, however, never offers any reasoning beyond this assertion of "possible inappropriateness" and never explains why it would ever be inappropriate.

Independent traders should be able to establish positions at the outer bound of any position limit. Those traders are merely complying with the law and the outer bounds set by the Commission which, by law, must be "necessary to prevent" excessive speculation. It would be a different case if the traders were not independent and they were acting in concert to amass positions that greatly exceeded CFTC position limits.[16] But if the account controllers are "independent," then aggregation is inappropriate and, more statutorily relevant, "unnecessary to prevent" excessive speculation. CEA § 4a(a).

The CFTC's proposal suggests that passive investments in an entity which engages in energy futures trading in connection with its business will trigger an automatic aggregation requirement by virtue of the "common ownership" standard. This aspect of the proposal has potentially major implications for investments in the energy sector. Similarly, the proposal calls into question the ability of FCMs to rely on Rule 150.4(d) which codifies the CFTC 1979 Statement of Aggregation Policy. For example, an FCM might not be able to disaggregate proprietary positions of the FCM and those entered into independently by its advisory affiliate on behalf of clients.

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15 The exchanges have applied the CFTC Part 150 aggregation standards as well for many years; the potential impact of the CFTC's proposals could extend beyond just the energy sector.

16 Perhaps this is what the CFTC hints at when it states: "[C]urrent account disaggregation exceptions for the agricultural contracts enumerated in regulation 150.2 may be incompatible with the proposed Federal speculative position limit framework, however, and used to circumvent its requirements." 75 Fed. Reg. at 4161. The answer to that concern is to enforce the independence requirements to catch anyone trying to circumvent them, not to bar those who are truly independent from trading under position limits. This might be different if the CFTC had identified any instances of abuse under the current standards which need to be addressed. The Commission has not, however, identified any such problems with the current standards.

The proposal's departure from the Commission's Part 150 standards also may be unworkable and surely will sharply increase the cost of compliance. Both market participants that qualify as "eligible entities," including FCMs, which maintain decentralized and international trading operations with multiple independent account controllers would find it extremely difficult, and very costly, to monitor and keep a running tally of each of these disparate trading operations in the over 100 different contracts affected by the proposal. Market participants and their FCMs will need to develop or purchase expensive new compliance systems in this area. They will also have to build new Information Technology (IT) programs for the proposed aggregation standards because their current IT programs only code for the Part 150 standards. Implementing these new compliance systems will come at a cost that would be burdensome and have no identifiable corresponding benefit other than the Commission's "may not be appropriate" assertion. FCMs have implemented effective systems for complying with the CFTC's Part 150 rules. The Commission should allow FCMs to continue to rely on those systems by applying the Part 150 standards to aggregation and disaggregation for energy limits.

E. The Proposal's Costs Are High, Not "Minimal;" Its Benefits Are Uncertain.

The Commission concludes that the costs of its proposal would be "minimal." 75 Fed. Reg. at 4164. This assessment includes both compliance costs and the impact of the proposal on market liquidity, price discovery, efficient hedging and market surveillance efforts. FIA respectfully disagrees with the Commission.

We agree with CFTC Commissioner Michael Dunn's statement in the Federal Register. Having reprised his August 2009 fear of the adverse consequences that would flow out of any energy position limits that did not apply to OTC and foreign markets, Commissioner Dunn wrote: "I believe this is still true today, and that forging ahead on a position limits regime for political expediency is not the course of action that this agency needs or one that promotes the health and integrity of the futures industry in the United States." 75 Fed. Reg. at 4164. FIA too is concerned with the health and integrity of the futures industry and, as we have discussed earlier in this letter, we believe the costs of the proposal are high in terms of compromising the public interests served by the energy futures markets.

If the proposals are adopted, many market participants are likely to shift their market activities to other venues to avoid the legal uncertainty regarding the application of the limits and their proposed exemptions. In particular, as our examples have shown, the proposals' crowding out rules would be particularly difficult to apply in a dynamic market with ever-changing trading operations and strategies. Even worse, failure to comply with the CFTC-set limits carries serious legal consequences. Moreover, the proposed energy position limits will impose significant compliance, monitoring, and management costs on market participants. The lack of clarity imbuing the proposal will further complicate their efforts. For example, no industry source seems to be able to replicate the CFTC's open interest calculation that serves as the basis for computing position limits.

The Commission answers by saying that the position limits it proposes would "possibly" affect only ten traders. 75 Fed. Reg. at 4170. This assessment surely understates the compliance costs and challenges that would be imposed by the new rules and grossly underestimates the substantial market-wide impact of the proposed rules. By diverting liquidity, the limits would likely affect most, if not all, of those who trade energy or use energy futures prices in their businesses. The exemptions also could add to energy price volatility and risks by discouraging hedging activity at least by swap dealers, if not other hedgers. Moreover, it is unclear whether the Commission's determination was made after taking into account the possible effect of the proposal's departure from the Commission's Part 150 aggregation standards. If nothing else, the CFTC's changes to its aggregation policies mean that it is likely that many multiples of ten traders would actually have to reduce positions in the energy futures markets.

Against this assessment of costs, the CFTC asserts only unspecified possible "prophylactic" benefits the proposal "may" cause. 75 Fed. Reg. at 4164. Having found no extant "excessive speculation," the Commission is left to propose limits that "may" prevent adverse prices, even though the Commission has multiple weapons in its arsenal already to achieve market integrity. The Commission's desire to improve its market surveillance of multiple trading platforms in the same commodity is commendable but could be achieved more effectively through a Commission-initiated position accountability effort, not hard limits that would affect only futures and that are contrary to the public interest.

FIA urges the Commission to reassess its cost-benefit analysis of the proposal.

F. The Proposal Would Be Arbitrary And Capricious If Adopted In Its Current Form.

FIA respectfully urges the Commission not to adopt these proposals, hopefully for any, or many, of the reasons we express in this letter. As always, FIA stands ready to work with the Commission and its staff to address any market integrity issues. We would be pleased to discuss how best to improve market surveillance given the modern evolution of derivatives trading. As we noted at the outset, price manipulation and price distortions are public enemy number one and should never be tolerated.

If the Commission adopts its proposals in their current form, however, FIA believes that a reviewing court would find them to be arbitrary and capricious under the Administrative Procedure Act. In order for an agency to show that its action is not arbitrary and capricious, the agency must have "examine[d] the relevant data and articulate[d] a satisfactory explanation for its action." *Motor Vehicle Mfrs. Ass'n v. State Farm Mutual Auto Ins. Co.*, 463 U.S. 29, 43 (1983). The Commission has not done either here. More specifically, its failure to make a statutorily required finding and its failure to ground its assumptions in the factual record are indicative of arbitrary and capricious agency action. *See Pub. Citizen v. Fed. Motor Carrier Safety Admin.*, 374 F.3d 1209 (D.C. Cir. 2004) (agency's promulgation of a rule increasing the number of hours truck drivers could spend behind the wheel, but decreasing maximum work day, was arbitrary and capricious where the agency did not make a statutorily required finding about how the rule would affect the "physical condition" of the drivers); *Comcast Corp. v. FCC*, 579 F.3d 1, 8 (D.C. Cir. 2009) (agency's rule capping market share any single cable operator could serve at 30% was arbitrary and capricious where the record failed to support the agency's assumption that an operator serving 30% of the market posed a threat to competition).

CONCLUSION

FIA knows the Commission is under great pressure from members of Congress and certain market participants to address the volatile energy pricing allegedly caused by speculation. FIA has commended the Commission for the informative and fact-based hearings the Commission held on this subject last summer. Our review of the hearing record confirmed to us the complexity of energy pricing generally and the issues related to any necessary position limits specifically. We still do not believe the case has been made, in any credible way, that any type of speculation drove energy prices to artificial levels, either high or low. We are pleased that the Commission's Federal Register Notice in this rulemaking reaches a similar conclusion.

FIA strongly urges the Commission to defer action on position limits until Congress enacts its financial reform legislation. The Commission's existing market integrity protection systems are strong and its special call program has enhanced even those traditional safeguards. FIA respectfully submits that the Commission's proposals would disserve the congressionally-identified national public interests and should not be adopted, even if they complied with the relevant statutes. We look forward to working with the Commission to help it achieve our shared objective of preventing price manipulations and distortions in the energy markets.

Respectfully yours,

John M. Damgard
President
Futures Industry Association

cc: Honorable Gary Gensler, Chairman
Honorable Michael Dunn, Commissioner
Honorable Jill E. Sommers, Commissioner
Honorable Bart Chilton, Commissioner
Honorable Scott O'Malia, Commissioner
Stephen Sherrod, Acting Director of Surveillance
David P. Van Wagner, Chief Counsel
Donald Heitman, Senior Special Counsel
Bruce Fekrat, Special Counsel

Response of the Futures Industry Association to the Questions Raised by the CFTC in its Federal Register Notice dated January 26, 2010

1. **Are Federal speculative position limits for energy contracts traded on reporting markets necessary to "diminish, eliminate, or prevent" the burdens on interstate commerce that may result from position concentrations in such contracts?**

- No. If the CFTC found existing burdensome excessive speculation, it could impose limits as necessary to eliminate or diminish that condition. The CFTC has not found excessive speculation to exist. FIA agrees with the "non-finding." In the absence of extant excessive speculation, by law the CFTC must find that speculative limits are "necessary to prevent" the burdens of sudden or unreasonable price fluctuations or unwarranted price changes. CEA § 4a. The CFTC has not made that required finding for its proposal. Perhaps the CFTC believes its proposed limits would be "helpful" but are not "necessary." FIA does not believe the proposed limits (or federal limits generally) could be found to be necessary now because other, more effective means exist to enhance CFTC market surveillance and prevent energy price manipulations and distortions. Existing CFTC and exchange market surveillance, special call, position limit and position accountability systems provide a strong system to deter and detect artificial, manipulated prices. The CFTC might want to consider adopting its own accountability levels for energy commodities traded on multiple trading platforms. When used with targeted CFTC special calls, accountability levels would assist the Commission in promoting market integrity and fair trading.

- The question is not posed in a manner consistent with the statute. The first two sentences of Section 4a which authorize the imposition of limits never use the term "position concentrations." In any event, as our comment letter shows, the Commission's proposal would limit speculation even in markets where position concentrations do not exist. Position limits are a blunt instrument to address concerns about excessive concentrations.

2. Are there methods other than Federal speculative position limits that should be utilized to diminish, eliminate, or prevent such burdens?

- The burden referred to is the burden of excessive speculation. Section 4a defines that term to mean speculation that causes prices to fluctuate suddenly or unreasonably or change in an unwarranted manner. Futures markets are dynamic. Prices fluctuate or change constantly in order to make certain that futures markets serve their price discovery and risk management purposes. The fact that these fluctuations or changes occur does not make them unreasonable or unwarranted.
- But prices can be affected by artificial manipulative forces. When that occurs, FIA believes the CFTC already has excellent tools to conduct effective market surveillance and deter or detect any misconduct by any market participants, whether speculators or hedgers.
- FIA is not aware of any gaps or weaknesses in the CFTC market surveillance system. FIA strongly endorses an active CFTC market surveillance effort. The CFTC does have a greater market surveillance responsibility when competing exchanges or platforms trade the same or similar commodities because no single exchange is able to see the whole market as the CFTC

could. In those situations, the CFTC might consider implementing its own accountability levels and using its special call authority to obtain more information about the activities of specific market participants.

3. How should the Commission evaluate the potential effect of Federal speculative position limits on the liquidity, market efficiency and price discovery capabilities of referenced energy contracts in determining whether to establish position limits for such contracts?

- FIA believes the imposition of CFTC position limits now would harm the public interests in price discovery and efficient risk management. The CFTC has no authority to impose limits on OTC swaps or foreign markets. Traders that want more price exposure than would be possible under the CFTC-imposed limits could be expected to move their trading activity to swap markets, foreign futures exchanges or worse to physical markets. This shift would harm the public interests in price discovery and efficient risk management that are served by U.S. futures markets while also harming CFTC market surveillance. In the absence of new legislative authority in this area, the CFTC should postpone imposing limits on energy commodities while Congress continues its deliberations. Of course, the CFTC should also continue its vigorous market surveillance efforts.

4. Under the class approach to grouping contracts as discussed herein, how should contracts that do not cash settle to the price of a single contract, but settle to the average price of a subgroup of contracts within a class be treated during the spot month for the purposes of enforcing the proposed speculative position limits?

- FIA has no comment.

5. Under proposed regulation 151.2(b)(1)(i), the Commission would establish an all-months-combined aggregate position limit equal to 10% of the average combined futures and option contract open interest aggregated across all reporting markets for the most recent calendar year up to 25,000 contracts, with a marginal increase of 2.5% of open interest thereafter. As an alternative to this approach to an all-months-combined

aggregate position limit, the Commission requests comment on whether an additional increment with a marginal increase larger than 2.5% would be adequate to prevent excessive speculation in the referenced energy contracts. An additional increment would permit traders to hold larger positions relative to total open positions in the referenced energy contracts, in comparison to the proposed formula. For example, the Commission could fix the all-months-combined aggregate position limit at 10% of the prior year's average open interest up to 25,000 contracts, with a marginal increase of 5% up to 300,000 contracts and a marginal increase of 2.5% thereafter. Assuming the prior year's average open interest equaled 300,000 contracts, an all-months-combined aggregate position limit would be fixed at 9,400 contracts under the proposed rule and 16,300 contracts under the alternative.

- FIA does not believe the proposed limits have been shown to be necessary to prevent excessive speculation in energy commodities. That is the statutory precondition for limits. FIA also does not believe generally that excessive speculation exists for energy commodities, as the statute defines that term. (The CFTC has never found excessive speculation to exist.) Given that position, FIA would support any limits that are higher than those proposed because they would have less impact on market liquidity and price discovery. 16,300 would be better than 9,400. But FIA still does not believe that any limits are or have been shown to be necessary.
- Question 5 asks whether a higher limit would be adequate; the statute asks a different question: whether any limits are necessary. We believe the answer to the statute's question is "no" based on the evidence we have seen.

6. Should customary position sizes held by speculative traders be a factor in moderating the limit levels proposed by the Commission? In this connection, the Commission notes that current regulation 150.5(c) states contract markets may adjust their speculative limit levels "based on position sizes customarily held by speculative traders on the contract market, which shall not be extraordinarily large relative to total open positions in the contract * * *"

- Today position limits apply to the last trading days in the spot month because of concerns relating to the potential for congestion and pricing abnormalities in the delivery month, as suggested by the statutory provisions applicable to contract markets. CFTC Regulation 150.5(c) allows contract markets to take into account customary positions for speculators as a factor in administering existing limits. That seems to be an appropriate regulatory interest for the delivery month.

- The fact that the largest speculators customarily hold positions of a certain size is often not a meaningful factor in terms of market surveillance or preventative position limits. What is a customary position level for larger traders may depend on many market factors that have nothing to do with excessive speculation that could lead to price manipulations or distortions.
- Limits tied to customary levels might unduly restrict market liquidity when it would be better to allow more speculation to be brought to the market to assume some of the risk hedgers want to avoid.

7. Reporting markets that list referenced energy contracts, as defined by the proposed regulations, would continue to be responsible for maintaining their own position limits (so long as they are not higher than the limits fixed by the Commission) or position accountability rules. The Commission seeks comment on whether it should issue acceptable practices that adopt formal guidelines and procedures for implementing position accountability rules.

- FIA does not see a need for acceptable practices in this area unless the CFTC identifies specific problems.

8. Proposed regulation 151.3(a)(2) would establish a swap dealer risk management exemption whereby swap dealers would be granted a position limit exemption for positions that are held to offset risks associated with customer initiated swap agreements that are linked to a referenced energy contract but that do not qualify as *bona fide* hedge positions. The swap dealer risk management exemption would be capped at twice the size of any otherwise applicable all-months-combined or single non-spot-month position limit. The Commission seeks comment on any alternatives to this proposed approach. The Commission seeks particular comment on the feasibility of a "look-through" exemption for swap dealers such that dealers would receive exemptions for

positions offsetting risks resulting from swap agreements opposite counterparties who would have been entitled to a hedge exemption if they had hedged their exposure directly in the futures markets. How viable is such an approach given the Commission's lack of regulatory authority over the OTC swap markets?

- FIA does not believe that the "look through" for physical hedger exemption for swap dealers is viable or is an appropriate means of characterizing the status of a dealer's futures positions to offset price risk.
- FIA does believe that any swap dealer that establishes a futures position as an economically appropriate means of managing or reducing price risk from open swap transactions should not be subject to speculative position limits for those positions. Managing or reducing existing price risks should never be confused with speculation. But dealers should be subject to the speculative position limit for their speculative positions, just like every other market participant.
- Moreover, FIA believes that there is no reason to subject swap dealers to a more restrictive exemption than other bona fide hedgers through an absolute cap of twice the speculative position limit. Imposing an artificial cap may actually have the negative consequence of encouraging more risk to be held outside the CFTC regulated markets with their attendant counterparty credit risk protections. Just like other bona fide hedgers, dealers should be allowed to exceed the speculative position limit by an amount based on their demonstration of need to a reporting market or the CFTC.
- FIA also believes that if energy futures and economically equivalent swaps were subject to the same limits, most swap dealers would not need an exemption in any event. That is another reason we believe CFTC action on limits before Congress enacts regulatory reform legislation is premature.

9. Proposed regulation 20.02 would require swap dealers to file with the Commission certain information in connection with their risk management exemptions to ensure that the Commission can adequately assess their need for an exemption. The Commission invites comment on whether these requirements are sufficient. In the alternative, should the Commission limit these filing requirements, and instead rely upon its regulation 18.05 special call authority to assess the merit of swap dealer risk management exemption requests?

- FIA would defer to ISDA on this question generally.
- We do not believe the CFTC's special call authority should be used on a regular basis to obtain information about exemption requests.

10. The Commission's proposed part 151 regulations for referenced energy contracts would set forth a comprehensive regime of position limit, exemption and aggregation requirements that would operate separately from the current position limit, exemption and aggregation requirements for agricultural contracts set forth in part 150 of the Commission's regulations. While proposed part 151 borrows many features of part 150, there are notable distinctions between the two, including their methods of position limit calculation and treatment of positions held by swap dealers. The Commission seeks comment on what, if any, of the distinctive features of the position limit framework proposed herein, such as aggregate position limits and the swap dealer limited risk management exemption, should be applied to the agricultural commodities listed in part 150 of the Commission's regulations.

- FIA believes that the question should be reversed. If the CFTC adopts energy limits in accordance with Section 4a of the CEA, the CFTC should follow its agricultural position limit policies for purposes of exemption and aggregation policy in the energy area. FIA knows of no basis for the CFTC to impose different standards for agriculture and energy. This disparity will increase compliance costs and uncertainty. We strongly urge the CFTC to reconsider.

11. The Commission is considering establishing speculative position limits for contracts based on other physical commodities with finite supply such as precious metal and soft agricultural commodity contracts. The Commission invites comment on which aspects of the current speculative position limit framework for the agricultural commodity contracts and the framework proposed herein for the major energy commodity contracts (such as proposed position limits based on a percentage of open interest and the proposed exemptions from the speculative position limits) are most relevant to contracts based on other physical commodities with finite supply such as precious metal and soft agricultural commodity contracts.

- FIA believes any new position limits are premature and would harm the public interest if adopted at this time because limits on futures would encourage many market participants to shift their positions to swap markets or foreign futures exchanges which are not subject to CFTC limits.
- If the CFTC could adopt limits now that are consistent with its statutory obligations, FIA believes it should follow the exemption and aggregation framework from the CFTC Part 150 rules.

12. As discussed previously, the Commission has followed a policy since 2008 of conditioning FBOT no-action relief on the requirement that FBOTs with contracts that link to CFTC-regulated contracts have position limits that are comparable to the position limits applicable to CFTC-regulated contracts. If the Commission adopts the proposed rulemaking, should it continue, or modify in any way, this policy to address FBOT contracts that would be linked to any referenced energy contract as defined by the proposed regulations?

- FIA has addressed this question before. We continue to believe that the issue should only arise when an FBOT offers direct access to U.S. traders to a contract that is linked to the settlement price of a contract traded on a DCM (or a CFTC-found significant price discovery contract). In that situation, FIA strongly recommends that the CFTC work with foreign regulators to adopt an appropriate market surveillance system that may or may not include position limits.

13. The Commission notes that Congress is currently considering legislation that would revise the Commission's section 4a(a) position limit authority to extend beyond positions in reporting market contracts to reach positions in OTC derivative instruments and FBOT contracts. Under some of these revisions, the Commission would be authorized to set limits for positions held in OTC derivative instruments and FBOT contracts.[1] The Commission seeks comment on how it should take this pending legislation into account in proposing Federal speculative position limits.

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1 *See, e.g.*, Over-the-Counter Derivatives Markets Act of 2009 (OCDMA), H.R. 3795, 111th Congress, 1st Sess (2009). OCDMA would also abolish the DTEF, ECM and ECM-SPDC market categories.

- FIA believes the CFTC should wait for Congress to act. CFTC action now would confuse market participants, harm the public interest and make more work for the CFTC itself at a time when it claims its resources are being strained. In addition, the CFTC's proposal might have to be substantially revised depending on the legislation Congress adopts.

- FIA also notes that, in contrast to acting now, waiting to act would not create any significant harm given that the CFTC has not found that excessive speculation existed or now exists in the energy market.

14. Under proposed regulation 151.2, the Commission would set spot-month and all-months-combined position limits annually.

a. Should spot-month position limits be set on a more frequent basis given the potential for disruptions in deliverable supplies for referenced energy contracts?

- No. The DCMs should handle spot-month limits and police directly the delivery process.

b. Should the Commission establish, by using a rolling-average of open interest instead of a simple average for example, all months-combined position limits on a more frequent basis? If so, what reasons would support such action?

- No. More frequent adjustments would destabilize the markets by injecting uncertainty and would increase administrative costs for market participants' compliance activities. Congress has addressed a related issue and advised the CFTC against changing contract terms and other trading conditions for agricultural contracts with open interest. The CFTC should respect all traders' need for legal certainty when they establish positions in deferred months.

15. Concerns have been raised about the impact of large, passive, and unleveraged long-only positions on the futures markets. Instead of using the futures markets for risk transference, traders that own such positions treat commodity futures contracts as distinct assets that can be held for an appreciable duration. This notice of rulemaking does not propose regulations that would categorize such positions for the

purpose of applying different regulatory standards. Rather, the owners of such positions are treated as other investors that would be subject to the proposed speculative position limits.

a. Should the Commission propose regulations to limit the positions of passive long traders?

- No, as we said in August 2009, there is no credible case against index traders.

b. If so, what criteria should the Commission employ to identify and define such traders and positions?

c. Assuming that passive long traders can properly be identified and defined, how and to what extent should the Commission limit their participation in the futures markets?

- Passive long traders are difficult to define with certainty. Their participation should not be limited.

d. If passive long positions should be limited in the aggregate, would it be feasible for the Commission to apportion market space amongst various traders that wish to establish passive long positions?

- No.

e. What unintended consequences are likely to result from the Commission's implementation of passive long position limits?

- Price discovery will be harmed and portfolio diversification will be made more expensive and inefficient. Hedging in deferred months would become more expensive. Index funds could buy and hold physicals. That could artificially impact prices, and the CFTC would have caused that harm inadvertently.

f. Should diversified commodity indexes be defined with greater particularity?

- Yes, more legal certainty can't hurt.

16. Under the proposed regulations, a swap dealer seeking a risk management exemption would apply directly to the Commission for the exemption. Should such

exemptions be processed by the reporting markets as would be the case with *bona fide* hedge exemptions under the proposed regulations?

- FIA believes the BFH exemptions should be handled by the exchanges.
- FIA believes the RM exemptions could be handled by either the CFTC or the exchanges expeditiously, with the proper guidance.

17. In implementing initial spot-month speculative position limits, if the notice of proposed rulemaking is finalized, should the Commission:

a. Issue special calls for information to the reporting markets to assess the size of a contract's deliverable supply;

b. Use the levels that are currently used by the exchanges; or

c. Undertake an independent calculation of deliverable supply without substantial reliance on exchange estimates?

- Consistent with the reporting markets' regulatory interest in the delivery process, the CFTC should rely on those markets for deliverable supply information.