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Atlanta Calgary Chicago Houston London New York Singapore

April 6, 2010

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

***Re: Comments on Proposed Federal Speculative Position Limits on Referenced Energy Contracts***

Dear Mr. Stawick:

IntercontinentalExchange, Inc. (ICE) welcomes the opportunity to comment on the Commission's proposed rulemaking on federal speculative position limits for referenced energy contracts. As background, ICE was established in 2000 as an over-the-counter (OTC) marketplace with the goal of providing transparency and a level playing field for the previously opaque, fragmented energy market. Since that time, ICE has grown significantly through organic growth fostered by product, technology and clearing innovation, and by acquisition of futures exchanges that have broadened its product offerings and risk management services. Today, ICE operates a leading global marketplace for futures and OTC derivatives across a variety of product classes, including agricultural and energy commodities, foreign exchange and equity indexes. Commercial market participants rely on our products to hedge and manage risk and investors in these markets provide necessary liquidity.

***Introduction***

ICE believes proper regulation is essential for ensuring that market participants— as well as the broader public — have confidence in the price formation process that takes place in our markets. This assurance of integrity lies at the heart of the futures exchange model. The U.S. energy futures markets, governed by the Commission's comprehensive-but-flexible regulatory structure, have permitted commercial and professional market users to hedge future price risk in an efficient and cost-effective manner. In particular, energy futures market participants have benefited from intense competition between multiple exchanges, clearing houses and brokers to a degree unmatched in other markets.

It is often tempting for policy makers to take steps to address what they perceive to be structural problems in markets during times when markets are sending unpopular price signals. While well intentioned, these measures often fail to achieve their desired objectives or, worse, lead to unintended consequences such as ***increased price volatility*** and ***distortion of important price signals*** that would otherwise have been conveyed by a

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freely operating market. If policy changes are not carefully tailored to address actual problems in the market, such changes could ultimately leave our country, its businesses, and American consumers in a ***worse position in the long run***, unable to ***prepare today for what everyone – policy makers, businesses and consumers alike – agree will be a difficult energy future.***

In this regard, ICE notes that no investigation or quantitative study has demonstrated that speculation was the cause of increased energy commodity prices in 2008. Indeed, it is telling that commodities for which there was no active futures market experienced ***similar or even larger price increases*** as those for which there are active futures markets. Subsequent enhancements to position reporting, including disaggregated historical and current large-trader reports, have also demonstrated that the U.S. energy markets offer a healthy balance of commercial and speculative interest, while failing to tie price increases with speculative buying. In the course of setting policy, it is also critically important to recognize that deep, liquid markets, with broad speculative participation, are better at price discovery and are less susceptible to manipulation. Further, with reasonable and effective reporting structures in place, the Commission and other agencies will have a clear, comprehensive picture of market activity.

Against this backdrop, the Commission has proposed significant changes to the position limit regime for energy commodities. Protecting the integrity of the energy derivatives markets from excessive speculation is a laudable goal, but it is important to note that the Commission has neither demonstrated nor determined that excessive speculation occurred in the energy markets. In addition, the Commission's position limit proposal comes at a time of significant flux in derivatives regulation. Congress is currently considering legislation that would modify the derivatives markets structure by mandating that standardized transactions be conducted on an exchange and be centrally cleared. By implementing its proposed position limit regime, the Commission may inadvertently restrict the ability of market participants to put positions into clearing houses at the same time that Congress is requiring more, or all, positions be cleared. In addition, while Congress has proposed that the Commission have greater authority over the OTC markets, such authority has not yet been granted, and the implementation of the Commission's new position limit rules could result in a migration of business off of futures markets and transparent electronic platforms and out of the reach of regulators. Given these factors, the Commission should carefully consider the timing of the proposal given the limited powers of the Commission at this time.

In addition, tying position limits to excessive speculation, especially without a finding of excessive speculation, could lead the Commission to play the role of price authority. Every unpopular price may lead to allegations of excess speculation and calls for the position limits to be adjusted.[1] Instead, position limits should be set according to market size to prevent manipulation and delivery disruptions, and not to influence commodity price levels. In determining position limits or accountability levels, the Commission should consider the entire size of the relevant energy market– both exchange-traded and OTC and both domestic and domestically-linked. While the feasibility or necessity of OTC position limits is not the subject of this rulemaking, it is clear that the Commission has the authority to collect data on the OTC markets. In fact, the Commission is currently doing so in publishing certain data in the large trader reports and has already deemed the largest OTC U.S. natural gas contract an SPDC with attendant position limits and large trader reporting. Thus, the Commission should set position limits not based upon current activity alone, but to permit growing participation in the energy markets. Failing to accurately assess market size and thus, liquidity needs, in setting position limits, accountability levels and appropriate exemptions will likely result in artificially low limits and create barriers to a well-functioning, centrally cleared, regulated and competitive derivatives market in the U.S.

Should the Commission decide that the modification of the existing position limits is nevertheless appropriate in the energy markets, ICE respectfully offers the following comments regarding the framework outlined in the Commission's proposed rule making.

***Framework for Commission's Proposal***

The Commission's proposed position limit regime for energy markets adopts the position limit regime that the Commission currently uses for agricultural commodities. It is important to note at the outset that certain of the key U.S. agricultural markets guided by these limits are plagued by long-standing price convergence issues at settlement. Conversely, the market structure in energy futures does not face these issues and hedging physical exposure is very reliable as a result.

The agricultural position limit regime was first established in 1938, during the height of the Great Depression and amid concerns about low commodity prices. The regime places federal position limits on agricultural commodities both in the spot month, in single months, and in all months. Exchanges, as the self-regulatory organizations, administer the position limits pursuant to Commission oversight. However, the Commission has not demonstrated how the agricultural regime prevents "excessive speculation." On the contrary, as Commissioner Scott O'Malia noted in the Commission's January 14, 2010 hearing on position limits the Commission's agricultural limits did not cause agricultural market prices to behave differently from energy

[1] Note that historically, speculators have been blamed for *high* prices in energy, *low* prices in agricultural commodities, and *high* prices in gold.

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markets.[2] To the extent the Commission is arguing that its proposed limits would prevent energy price distortions, the apparent absence of any historical impact that position limits have had on agricultural market prices is relevant.

Moreover, the agricultural position limit regime was designed for domestic agricultural markets, which are very different markets than the global energy markets that the Commission seeks to address. These differences raise a number of important questions. For example, agricultural markets are primarily seasonal markets, and one can understand why an "all month" position limit regime could be important in such a market given the potential impact of positions held in all months on less liquid, seasonal markets. By comparison, energy markets such as crude oil are not seasonal markets per se and present different time horizons for hedging price risk. For example, farmers may be primarily interested in hedging price risk for the following season's crops. In comparison, energy companies generally hedge price risk far into the future given the long lead times for energy exploration and extraction. Imposition of "all month" position limits for these markets could sap vital speculative liquidity from long dated portions of the pricing curve, making future price signals less accurate and potentially inhibiting commercial market participants from being able to hedge long-dated price risk. This is not simply a theoretical concern – if markets are inhibited from sending accurate future price signals that reflect rising demand, important energy infrastructure may not be built today that will be needed to meet tomorrows energy needs.

In considering comments and proposed changes to this rulemaking, the Commission should not be constrained by the existing agricultural commodity framework, and should consider whether more liberal position limits are appropriate for energy markets given fundamental differences between the agricultural and energy markets.

***ICE Supports Aggregate Position Limits Administered by the Commission***

ICE has stated previously that the current position limit regime is outdated and does not take into account the existence of competing markets where economically equivalent contracts are traded across markets. In connection with its existing proposal, ICE supports the Commission's proposal to set aggregate position limits across trading venues for similar products.

Unlike other markets, liquidity is not concentrated at a single exchange or trading venue for energy commodities. Economically equivalent contracts may vary only where they are listed for trading or in how they are settled, and have repeatedly been shown to trade as ***a single market*** up until the final days of trading. For example, the June 2007 report published by the U.S. Senate Permanent Subcommittee on Investigations entitled,

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[2] Commodity Futures Trading Commission, Open Meeting Regarding Position Limits Rule (January 14, 2010) http://www.cftc.gov/PressRoom/Events/oeaevent011410.html

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"Excessive Speculation in the Natural Gas Market," focused on natural gas trading by the hedge fund, Amaranth Advisors, in both the NYMEX physical futures market and the ICE swaps market. The report is replete with analysis supporting the conclusion that these two markets, one physically settled and the other cash settled, were and are ***"functionally equivalent"*** and ***"provide economically identical hedging and risk management functions."***[3]

Given competitive markets and the fact that a number of exchanges can trade the same energy contract, ICE believes that the Commission, rather than an exchange, is the appropriate, neutral authority to set and administer aggregate position limits and hedge exemptions for U.S. energy futures or significant price discovery contracts. Only the Commission is in a position to view a market participant's positions across all venues, and to administer aggregate position limits in an objective manner that promotes, rather than impedes, market competition.

Having a dominant exchange set or administer position limits for a competing exchange is rife with potential for conflicts of interest. Further, the current process for determining position limits and hedge exemptions is completely opaque to ICE, to market participants and to the public in general, creating uncertainty about market integrity. If the Commission sets position limits and hedge exemptions, appropriate transparency and neutrality will be brought to the process. Because the Commission is charged by the Commodity Exchange Act to promote fair competition among markets, the Commission is the appropriate and transparent body to set and administer a position limit regimes.

### *Size of the Limits and Application to All Months*

In determining the appropriate levels for position limits, the Commission should consider the entire size of the energy market in question –across futures and OTC markets. While the feasibility or necessity of OTC position limits is not the subject of this rulemaking, it is clear that the Commission has the authority to collect data regarding the broader OTC markets. If the Commissions view is that position limits should cover

[3] *"The data analyzed by the Subcommittee, together with trader interviews, show that NYMEX and ICE are functionally equivalent markets. Natural gas traders use both markets; employing coordinated trading strategies...The data show that prices on one exchange affect the prices on the other."* ("Excessive Speculation in the Natural Gas Market", U.S. Senate Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, Sen. Carl Levin, Chairman, June 25, 2007, p. 3.)

*"The ICE natural gas swap and the NYMEX natural gas futures contract perform the same economic functions."* (Ibid, p. 29).

*"In sum, the structure of the ICE swaps and NYMEX futures contracts, the virtually identical prices of these two contracts, and the testimony of traders provide compelling evidence that the NYMEX natural gas futures contract and the corresponding ICE natural gas Henry Hub swap are economically indistinguishable financial instruments for risk-management purposes."* (Ibid, p. 36).

all segments of the market, including segments of the OTC market not presently covered, the size of the additional portion of the market should be considered in establishing the size of the limits being proposed. Failing to accurately assess market size in setting position limits and appropriate exemptions will likely result in artificially low limits and create barriers to a well-functioning, centrally cleared derivatives market.

In addition, the Commission should consider whether "all month" position limits are necessary or appropriate in energy markets for the long-dated portions of the trading curve. While hard limits in the expiration month and months surrounding the expiration month are appropriate, blanketing such limits across all contract months may have unintended effects on the proper operation of markets, such as draining speculative liquidity from the longer dated portions of the trading curve where it is most needed. It is axiomatic that the farther into the future an expression of price is made by a speculative market participant, the less connected or relevant such an expression is likely to be to the current spot market price. In order to promote greater liquidity in longer dated portions of the price curve – which would benefit commercial users attempting to hedge long dated risk -- the Commission should consider implementing its "all month" limit only on the front portion of the trading curve – for example, the first eighteen contract months – and maintain a position accountability regime for longer dated portions of the trading curve beyond that period.

It is important to consider that, in addition to commercial users, large speculative traders are often the only market participants willing to assume price risk in long dated portions of the trading curve where commercial are attempting to layoff price risk. As such, one potential impact of an "all month" regime is that such parties could choose to exit the longer dated portion of the market, sapping valuable liquidity from commercial market users and their ability to hedge long dated risk. Hard position limits in the first eighteen months of a contract and position accountability levels in the remainder of the contract would encourage speculative participants to assume risk in out months and give commercial participants the ability to hedge exposure farther in the future.

***ICE Supports Spot Month Position Limits Differentiating Between Cash and Physical Markets Subject to Refinement***

The Commission also proposes to adopt the agricultural position limit regime for spot month energy position limits. The spot month position limit would be set to 25% of deliverable capacity for the physically delivered energy contact. Historically, a 25% spot month limit is necessary to prevent corners and squeezes in a physical contract. In agricultural contracts, this is appropriate as the markets are physical and no meaningful cash-settled contracts presently exist. However, in the energy markets there is robust participation and liquidity in financially settled energy contracts that do not make claims on physical supply. In fact, today the vast majority of energy contracts are cash settled.

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As the Commission's proposal notes, a physically settled contract may have several financially settled equivalents. These products serve an important function in the market, providing market participants with the ability to hedge exposure to the final contract settlement price without basis risk and allow them to avoid the risk of physical delivery that is attendant to a physically delivered contract. Therefore, it is important that the Commission treats physically settled contracts and financially settled contracts differently in its proposal.

Limiting positions based on deliverable capacity could have negative consequences for firms requiring hedging and/or exposure to energy prices. For example, certain energy contracts, such as Henry Hub natural gas or West Texas Intermediate crude oil represent the national or international price of a commodity, and are used by firms to approximate the national price of that commodity in their hedging strategies. These firms are not participants in the physical delivery process and the location of the physical hub is of no importance. What is important, however, is their ability to hedge their exposure to an established benchmark. For example, the market created an OTC financially settled WTI swap contract specifically to allow hedgers, who reference CME's WTI futures settlement price in their physical crude oil purchase and sale contracts, to hedge the expiration price used in such contracts. Without such a mechanism, it is impossible to hedge the final futures settlement price, as a party would be forced to trade out of its position before final settlement or take delivery of physical crude oil at expiration.

Further, setting the spot month limit based upon deliverable supply may operate as unrealistic restraint on energy markets, resulting in unintended consequences. For example, faced with impractical limits, firms may be forced off-exchange into the bilateral OTC swaps market in order to hedge their exposure. The Commission should note that hard limits on financially settled energy contracts are new. The first hard limit was imposed on the February 2010 contract expiration for the CME and ICE cash settled Henry Hub contracts. The Commission should monitor the effect of these limits, including whether the limits inhibit orderly markets or other adverse impacts on market participants before adopting the proposed rule on spot month limits.

The Commission should be commended for recognizing the distinction between financially settled and physically settled contracts in proposing that a trader in a financially settled contracted be permitted to take a speculative position five times the spot month position limit for the physical contract if the trader exits the physically settled market in the spot month. However, this provision should be refined to better fit the market as it currently operates based upon the needs of market participants. In this regard, the Commission should consider (i) whether forcing these participants to leave the physically settled contract a full three days in advance of expiration is appropriate given the differences between physically and financially settled contracts, and (ii) whether having speculative traders exit the physical contract in this manner will impair price discovery by reducing liquidity and concentrating pricing power among a smaller group or market participants. Previous Congressional and Commission reviews of the energy markets have found that financially and physically settled contracts behave differently at expiration. As the Senate PSI Subcommittee states in its Report on Excessive Speculation in the Natural Gas Market:

> "[B]ecause the final settlement price for the ICE swap is defined to be the final settlement price of the NYMEX futures contract for the same month, the most significant divergence in price between the two contracts often ***occurs during the final 30 minutes of trading for the NYMEX contract***, which is used to compute the final NYMEX contract price. (The NYMEX final settlement price is computed by taking the volume-weighted average price of all trades during the final 30-minute period.) Most of the trading during these final 30 minutes will occur on NYMEX rather than ICE, and hence the NYMEX price often will "lead" the ICE price during this period. Based on the ICE and NYMEX data reviewed by the Subcommittee, as well as trader interviews, this final settlement period is the only period in which it can be categorically stated that one exchange "leads" the other in price."[4] (emphasis supplied)

Given compelling findings by the Commission and Congress that physically and financially settled contracts trade differently on the last day of expiration, the Commission should remove the three day prohibition from the conditional limit or limiting the "no trade" period for the physically delivered contract to the narrower window of trading.

***Concentration Limits for Single Exchanges Should Be Eliminated***

In addition to the aggregate position limits across exchanges and the spot month position limits, the Commission has proposed a concentration limit for single exchanges. The concentration limit would be set at 30% of the given exchange's open interest for all months and 20% of open interest in any single month, in each case based off the previous year open interest for that exchange. The Commission's rationale for the concentration limit is to prevent concentrated positions from causing abrupt price movements and distortions in the energy futures and options markets. Further, the Commission contends that a concentration limit will "fragment" the market and allow multiple traders to step in where a single trader was previously. The theory rests upon the assumption that large traders are crowding out smaller participants. ICE disagrees with setting an exchange

[4] Id, p. 34.

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concentration limit as such a limit ignores the premise that economically equivalent contracts operate as a single aggregate market, and such a limit may operate in an anticompetitive fashion.

Exhaustive hearings by Congress and the Commission over the last several years have concluded that economically equivalent contracts traded on two separate exchanges operate as ***a single aggregate market.*** For example, testifying before the House Agriculture Committee, Subcommittee on General Farm Commodities and Risk Management, in September 2007, Dr. James Newsome, former Commission Chairman and then President of NYMEX, stated "the two competing trading venues [ICE and NYMEX] are now tightly linked and highly interactive and in essence are simply two components of a broader derivatives market."[5] Further, as outlined in the Commission's Report on Exempt Commercial Markets, one of the Commission's underpinnings of new regulations for exempt commercial markets (ECMs) was that financially settled contracts could be arbitraged (and therefore affect) a physically settled contract.[6] Against this backdrop, the idea of imposing a concentration limit on an "individual exchange" basis is logically flawed, and poses the risk of being anti-competitive for smaller or new exchanges attempting to compete with an incumbent exchange.

Importantly, the Commodity Exchange Act mandates that the Commission "regulate the futures markets by the least anticompetitive means available." By design, a concentration position limit will impose smaller, or stricter, concentration limits in smaller markets. Applying a concentration limit for each individual exchange will inhibit competition by impeding liquidity in a competing market and effectively locking in the market share of existing exchanges. Large market participants will be effectively prohibited from leaving one market for a market that offers a competitive advantage, therefore limiting innovation and the choice that exists in today's markets. Slowly, over time, the dominant market will continue to gain market share, as liquidity attracts liquidity. In the end, the Commission may create the opposite of its intention to foster a diverse, highly competitive market.

One of the Commission's rationales for imposing the concentration limit is to create a market with a larger number of smaller participants. The Commission's proposal does not mention any study of the derivatives markets where the Commission has determined that crowding out is occurring, or that a concentration limit creates an influx of smaller market participants, nor what benefit a larger number of smaller participants

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[5] Testimony of Dr. James Newsome, Chief Executive Officer, New York Mercantile Exchange, before the Subcommittee on General Farm Commodities and Risk Management, United States House of Representatives (September 26, 2007).

[6] Commodity Futures Trading Commission Report on Exempt Commercial Markets (October 2007). http://www.cftc.gov/stellent/groups/public/@newsroom/documents/file/pr5403-07_ecmreport.pdf

would bring to the market. Before implementing new policies and regulations, the Commission should consider whether it is likely that new, smaller market participants will in fact enter the market and whether the creation of these smaller participants is necessarily a good or meaningful objective. Large, better capitalized market participants are generally able to manage risk more effectively than smaller market participants, especially in outlying months where less liquidity can result in higher volatility and price risk. Smaller, less well-capitalized market participants may default more frequently, leading to an increased risk to clearinghouses and clearing firms.

Finally, the Commission should understand that the concentration limit is duplicative of the aggregate limit and entirely unnecessary. The Commission's proposed aggregate limits are set, like the concentration limit, using open interest and would be designed to prevent corners, squeezes, and congestion in a market—all stated goals of the concentration limit. Another exchange set concentration limit, also based upon open interest, is unnecessary and would only create confusion for market participants, potentially biasing business to dominant exchanges with higher limits. If the Commission's concern is that a forced liquidation of a concentrated position could cause unwarranted price volatility in a market, then this issue would presumably be addressed by the aggregate limit across all markets. Having a separate exchange specific concentration limit would have no impact if the "one market" hypothesis is correct. Given that the "one market" concept is the cornerstone upon which the proposed rules are built, an exchange set concentration limit is logically flawed, redundant, and unnecessary.

A position accountability regime rather than an exchange specific concentration limit would serve the Commission's purpose. Accountability level regulation, by design, is intended to serve as an early warning system that triggers heightened surveillance by and contact from the exchange and puts the trader "on notice." Position accountability levels are set low for this very reason.[7] Such a regime would achieve the Commissions stated goals of preventing abrupt price movements and distortions in the derivatives markets through active position management far better than an exchange specific concentration limit, while avoiding the unintended and anticompetitive consequences outlined above. Therefore, instead of an exchange set position limit regime that duplicates and complicates the Commission set aggregate position limits and is anticompetitive, it is our view that the Commission should adopt a position accountability regime for concentration.

Further, from a risk and market integrity standpoint, unusually large or concentrated positions have been and continue to be a core area of focus for exchange and Commission market surveillance. Significant resources are deployed today toward the market surveillance and compliance missions of exchanges, with concentration being

[7] The current position accountability levels for ICE OTC's Henry Hub contract are approximately 1% of open interest, far lower than the proposed concentration limits.

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a paramount consideration, alongside other key aspects of price formation. Highly leveraged participants present risks to the clearinghouse, to their clearing members and potentially to the market. An effective risk surveillance program should identify these market participants and insure that they are not presenting undue risk.

Finally, if the Commission does adopt a concentration position limit, it should note that the limit creates opportunities for regulatory arbitrage or regulation-driven commercial opportunities. There exist many loopholes under the proposed rulemaking in this regard. For example, in the proposed rulemaking, the Commission divided physically delivered and cash settled contracts into separate classes. Within each of these classes, the Commission included options on futures ("options") that settle into an underlying futures contract. Options and futures open interest is then calculated separately, but thereafter aggregated in determining a "futures equivalent" open interest number for the purpose of establishing the exchange specific concentration limit. This number could be misleading. For example, when a trader holds open positions in both options and futures, the open interest is calculated regardless of the directional strategy that the trading may be employing. A trader could be holding 1,000 call options with a delta of 50 while also being short 500 contracts in the underlying contract. The trader would be considered delta neutral and – for position limit purposes – be considered flat. However, for open interest purposes, an exchange would receive the benefit of having 1,000 futures equivalent positions open for calculating position limits. In setting the concentration limit in this manner, the rules would provide an exchange with relatively more open options positions an outsized commercial advantage, while potentially permitting more speculative activity in that exchange's markets, counter to the aims of the Commission.

***The Commission's Proposal for Hedge Exemptions Should Be Modified***

As stated in the proposed rulemaking, the Commission would adopt the agricultural position limit regime for energy contracts. However, for hedge exemptions, the Commission is proposing a radical and unsupported departure from the current agricultural position limit regime and past Commission practice. The proposed hedge exemption provision would exempt *bona fide* hedging transactions from position limits, but unlike the agricultural position limit regime and current Commission practice, the new hedge exemption regime would prohibit a trader with a *bona fide* hedge exemption from holding a speculative position unless the speculative position is in the spot month. Likewise, a new risk management exemption would exempt swaps dealer risk management transactions from position limits, but again would prohibit traders from holding speculative positions. The Commission proposes this new regime to prevent "crowding out" of positions, though the Commission has not set forth any evidence of "crowding out" in energy derivatives markets

The Commission should note that the CEA states that, **"[n]o, rule, regulation, or**

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**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** . . . ." The Commission's proposal would invalidate a *bona fide* hedge exemption if a trader takes just one position that might be counted as speculative. This is contrary to a plain reading of Section 4a(c). The ultimate effect of the Commission's proposal would be to *create legal uncertainty for commercial participants* and force participants to take these transactions off-exchange or overseas.[8]

Similarly, the proposed risk management exemption is equally troublesome. The Commission should be commended for recognizing that swaps dealers perform a valuable service to the derivatives markets by allowing market participants to create customized hedging solutions for commercial firms, which are then offset by the swaps dealer on derivatives exchanges. However, the Commission again, forces traders seeking exemptions to choose whether to offset risk in the derivatives markets, or whether to engage in proprietary or speculative trading. This could have the impact of diminishing liquidity in the derivatives markets or concentrating risk in swaps dealers.

It is important to note that swaps dealers *are offsetting risk and transferring off-exchange positions* to transparent and centrally cleared markets. This is a stated goal of financial reform in every proposed bill under consideration by Congress. The Commission's proposal is at odds with these goals and would greatly impair the ability of swaps dealers to drive positions to exchange traded and centrally cleared markets.

Finally, ICE reiterates its view that the Commission should administer hedge exemptions and risk management exemptions in a transparent, market neutral manner. In any final rulemaking, it is our view that the Commission should keep the current hedge exemption and risk management regime, but should undertake the hedge exemption and risk management process at the Commission level.

***The Commission Should Consider Granting Passive Investors an Exemption***

Passive investors such as index funds and exchange traded funds (ETFs) have come under much scrutiny in the past few years as they are blamed for high commodity prices, often based on a lack of or flawed analysis.[9] However, quantitative studies have

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[8] For example, with an energy speculative position limit of 500 contracts, unintended scenarios could result: if a bona fide hedger holds 501 contracts pursuant to a hedge exemption and the nature of the hedge changes such that only 499 contracts are required, pursuant to the proposed rulemaking, the trader is (i) crowding out the market; (ii) has invalidated the bona fide hedge and (iii) has violated federal law. Keep in mind that this might not be the intent of the trader as a hedged transaction might turn into a speculative transaction given a change in business strategy. Thus, the trader, through no fault of her own, has just violated federal law.

[9] *See,* Michael Masters and Adam K. White, *The Accidental Hunt Brothers, Act II*, (2008) www.accidentalhuntbrothers.com

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demonstrated that, contrary to conventional wisdom, passive investors may have beneficial effects on the market, dampening volatility and improving liquidity outside of the spot months.[10] In addition, passive investment vehicles are beneficial to retail customers, including pension fund managers and equity investors, as these investments allow customers access to the futures markets -- and the attendant hedge against inflation -- without the cost and complexity of directly accessing futures markets.

Limiting ETF or index fund participation in the exchange traded derivatives markets will have three consequences: (i) it will expose retail passive investor customers to bilateral credit risks; (ii) it will increase price volatility and reduce liquidity; and (iii) it will force more retail customers to access the futures markets directly. Further, limiting the size of passive investors will lead to less efficiency, as the cost of operating the fund (which is passed to customers) can be spread out across more customers in a larger fund. Given the passive investment strategy, 10 smaller funds should have the same market impact as one larger fund. In light of these facts, the Commission should consider allowing passive investors, such as ETFs or index funds, to have a separate position exemption to speculative limits.

***The Commission's Proposal for Account Aggregation Should Be Eliminated***

In another departure from the agricultural position limit regime, the Commission has proposed to eliminate the "independent account controller" exemption from position limit aggregation rules. Currently, pursuant to the Commission's position limit rules, an account is aggregated for position limit purposes where a person controls 10% or greater of a common entity. However, if an account is independently controlled, then the position is not aggregated. This makes sense, for example, in the case of two independent operating companies of a corporate parent who independently trade under the same corporate entity, because they are not viewed as trading for the same account.

The Commission offers no explanation for its decision to depart from previous practice, other than stating that the independent controller exemption "would allow traders to establish a series of positions each near a proposed outer bound position limit without aggregation, may not be appropriate." Beyond this assertion, the Commission never explains why the independent account controller exemption would ever be inappropriate.

The proposal's departure from the Commission's Part 150 standards also may be unworkable and surely will drive up the cost of compliance without offering associated market benefits. Firms with decentralized and international trading operations through

[10] *See*, Scott Irwin, Dwight Sanders, Robert Merrin, *Devil or Angel? The Role of Speculation in the Recent Commodity Price Boom (and Bust)*, JOURNAL OF AGRICULTURAL AND APPLIED ECONOMICS, Vol. 41, No. 02, August 2009. **http://purl.umn.edu/53083**. *See also*, Philip K. Verleger, *Notes at the Margin*, January 11, 2010. http://www.pkverlegerllc.com/nam100111.pdf

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multiple independent account controllers would find it extremely difficult, and very costly, to track position limit levels for each of these disparate trading operations in the over 100 unique contracts affected by the proposal.

***Conclusion***

ICE commends the Commission for undertaking a comprehensive review of the energy market position limit regime and we appreciate the opportunity to comment. We ask that the Commission be prudent in enacting a position limit regime and remain mindful of the consequences of miscalculation. Should the Commission determine that it should move forward in implementing a revised position limit regime for energy, in summary ICE recommends that:

- the Commission should set aggregate position limits across markets, but should consider whether the "all month" limit should apply across all contract months;
- the Commission should set spot month limits by differentiating between financially settled and physically settled markets;
- the Commission eliminate the anticompetitive exchange concentration limits;
- the Commission should not adopt the hedge exemption or risk management regime that ban firms with hedge or risk management exemptions from holding a speculative position;
- the Commission consider an exemption for passive investors; and
- the Commission should not eliminate the independent account controller exemption.

ICE thanks the Commission for the opportunity to comment on the proposed rule making.

Sincerely,

Trabue Bland

R. Trabue Bland
Director of Regulatory Affairs
and Assistant General Counsel

ICE

Atlanta Calgary Chicago Houston London New York Singapore

## Addendum

## ICE Responses to Questions Posed by the Commission's Notice of Proposed Rulemaking

**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. Position limits are meant to prevent corners, squeezes, and congestion. If the Commission revises its position limit scheme for energy contracts, it should do it for two reasons: (i) to strive for consistency across commodity products; and (ii) to insure that position limits are applied equally and fairly across exchanges.

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

- In general, speculation is an amorphous concept. Defined broadly, every transaction in a market is speculative in nature. For example, a hedger is speculating on future prices when placing a hedge. As such, excessive speculation is even harder to define. That is why ICE believes that the Commission should not tie position limit rulemaking to excessive speculation, but should instead focus on consistency across its jurisdictional markets and the prevention and detection of market manipulation, which differs significantly from excessive speculation. Tying position limits to excessive speculation may place the Commission in role of price arbiter, as any unpopular price will lead to the conclusion of "excess" speculation.

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- If the Commission believes that a price is unwarranted and the result of manipulation, it has the mandate and capabilities to investigate and punish any misconduct by any market participants, whether the participant is a speculator or a hedger.

**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?**

- Besides examining the effect on the number of participants, volume, and open interest in the market, the Commission should examine whether the speculative position limits, which by definition apply to speculators, are impacting price discovery and volatility by curtailing the valuable information that speculators bring to the market.

**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?**

- In grouping contracts together for position limits, the Commission should strive to treat economically equivalent contracts similarly. In addition, as with significant price discovery contracts, the Commission should examine the average price contract to see if it has a material effect on the underlying contracts.

**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**

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**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.**

- As stated in its comment letter, ICE believes that the Commission should set aggregate position limits across markets; however, ICE disagrees with the reasoning. The Commission should strive for consistency across jurisdiction and tying the position limit rulemaking to excessive speculation, without a finding that position limits have an effect on excessive speculation, could lead the Commission into the role of price arbiter.
- A higher limit is warranted if the limit achieves its intended purpose– to prevent squeezes and corners of a contract.

**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 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

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positions for speculators as a factor in administering existing limits. That seems to be an appropriate regulatory interest for the delivery month.

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.**

- ICE does not see a need for acceptable practices for exchange set position limits. In addition, as referenced in previous Commission rulemakings, acceptable practices are just one way to comply with a core principle. Formal guidelines or prescriptive rules are not compatible with acceptable practices.

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?**

- The Commission should seek authority from Congress to regulate the OTC swaps markets in order to ensure the most effective oversight regime.
- A swaps dealer is not a flow though entity; transactions may be offset indirectly in the futures markets. Therefore, a "look through" approach may be impractical or impossible to implement.

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- In addition, the Commission should keep in mind that in making a risk management exemption request, a swaps dealer is looking to offset risk. Artificially limiting this activity could end up concentrating risk elsewhere and could lead to less efficient hedging and risk management by major U.S. commercial entities.

**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?**

- The Commission's special call authority should not be used to obtain information about exemption requests; instead, the Commission should promulgate a rule detailing the information it requests and analyzing the burden on market participants.

**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.**

- As a general matter, the Commission should strive for consistency across all products. As ICE states in its comment letter, the Commission should follow its

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agricultural position limit rules and not adopt hedge exemption or account controller provisions of the rulemaking.

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.**

- Again, ICE believes that the Commission should strive for consistency in implementing its regulations. Treating products or classes of products inconsistently leads to confusion and to charges of creating a loophole. For example, in addition to examining energy, agricultural and metals markets, the Commission should examine whether aggregate position limits should be placed upon financial contracts such as Treasury futures or Eurodollars, as those contracts are also commodities with a finite supply.

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?**

- ICE's European subsidiary, ICE Futures Europe, has worked closely with the Commission and the FSA over the past decade on continuing to evolve its No Action Letter to respond to changing market conditions. ICE believes that it is clearly appropriate for exchanges that offer linked-contracts to operate under the

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rules that apply to US exchanges, though this is currently only applied to ICE Futures Europe. ICE Futures Europe has submitted more detailed comments on this topic.

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.[11] The Commission seeks comment on how it should take this pending legislation into account in proposing Federal Speculative position limits.**

- ICE believes that the Commission should take OTC derivatives into account when setting position limits. OTC and futures markets are often used in tandem by market participants to hedge risk. A position limit set too low in regards to the OTC market could thwart the policy goal of moving OTC derivatives onto exchanges.
- Separately, the Commission should be aware that setting position limits for bilateral OTC transactions could be problematic, as forcing a participant to exit a position in a bilateral contract could be punitive to an innocent counterparty.
- In regards to contracts listed on a foreign board of trade, as stated above, ICE believes that aggregate position limits on contracts linked to a U.S. exchange contract are warranted. However, the Commission cannot regulate the entire global financial system. It must defer to other regulators. Setting position limits on foreign contracts, such as Asian interest rates or EU emission credits, will

[11] *See, e.g*, Over-the-Counter Derivatives Markets Act of 2009 (OTCDMA), H.R. 4173, 111th Congress, 1st Sess. (2009).

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invite retaliation by foreign regulators and hamper the ability of the CFTC to work cooperatively with other regulators.

**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. In the event of a disruption, a change to the Commission set spot-month and all-months combined position limit would be too late, given the required notice and comment period. In addition, firms need time to implement the back-office systems needed for new position limits. Finally, the Commission should be aware that sudden and/or overly frequent position limit changes could introduce unnecessary uncertainty into markets and exacerbate the effects of these disruptions.

**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.

**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?**

- The Commission should be aware that limiting ETF or index fund participation in the exchange traded derivatives markets will have two consequences: (1) it will expose retail passive investor customers to bilateral credit risks; and (2) it will force more retail customers to access the futures markets directly.
- Passive investors looking for access to commodity markets will undoubtedly seek other avenues, such as equity investments in commodity-intensive or commodity-producing businesses, if not allowed to invest directly.

**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 investors, such as exchange traded funds, are an important way for retail customers to access derivatives markets. This is key as these participants use commodities to hedge against inflation and attendant rising commodity prices.

**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. Apportioning space in commodity markets would put the government in the place of picking winners in the passive investor space.

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

- Index funds or ETFs could buy the physical product or take transactions over the counter (which has happened previously). Their customers would be subject to

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counterparty risk. In addition, studies have shown that passive investors may have a dampening effect on commodity prices as they sell as prices rise and buy as prices decrease.[12] Eliminating passive investors could have adverse effects on markets, including increasing volatility.

**16. The proposed definition of referenced energy contract, diversified commodity index, and contracts of the same class are intended to be simple definitions that readily identify the affected contracts through an objective and administerial process without relying on the Commission's exercise of discretion.**

**a. Is the proposed definition of contracts of the same class for spot and non-spot months sufficiently inclusive?**

- Yes.

**b. Is it appropriate to define contracts of the same class during spot months to only include contracts that expire on the same day?**

- No, the appropriate class should include contracts that are economically equivalent, including penultimate (LD2) and LD3 contracts.

**c. Should diversified commodity indexes be defined with greater particularity?**

- Yes.

**17. 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?**

- ICE believes that the Commission should handle hedge and risk management exemptions.

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[12] *See, e.g.*, Philip K. Verleger, *Notes at the Margin*, January 11, 2010, http://www.pkverlegerllc.com/nam100111.pdf

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**18. 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?**

- The Commission should rely on reporting markets for deliverable supply information. Again, the Commission should not use the special call provisions to undertake a regular, routine reporting scheme. It should propose, for notice and comment, a rulemaking to request such information.