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COMMENT

April 22, 2010

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OFFICE OF THE SECRETARIAT
C.F.T.C.

Via email: Secretary@CFTC.gov

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

Re: Proposed Federal Speculative Position Limits for Referenced Energy Contracts (and Associated Regulations (75 Federal Register 4144 (CFTC, January 26, 2010)) (the "Proposal")

Dear Mr. Stawick:

DB Commodity Services LLC ("DBCS"), a Delaware limited liability company that is a registered commodity pool operator ("CPO") and commodity trading advisor ("CTA"), welcomes the opportunity to submit this letter in response to the Commodity Futures Trading Commission's ("Commission" or "CFTC") request for comments in respect of the Proposal. DBCS has been registered with the Commission and has been a member of the National Futures Association since 2005. Its principal place of business is 60 Wall Street, New York, New York 10005, telephone number (212) 250-5883. DBCS is a wholly-owned subsidiary of DB U.S. Financial Markets Holding Corporation, which is a wholly-owned, indirect subsidiary of Deutsche Bank AG. DBCS currently operates 11 commodity pools traded on NYSE Arca, a national securities exchange, in 2009 having in the aggregate over 900,000 public investors and approximately $11bn in investor assets.

In our comments, Section A offers general remarks, and Section B responds to certain questions posed by the Commission.

A. General Comments.

The futures markets serve a vital role in the health of our economic system: they provide a critical price discovery mechanism, enable hedgers to offset risks, allow speculators to express their views on price movements in the various futures contracts (whether up or down) and, via passive index funds, permit investors to hedge against inflation and diversify their investment portfolios. DBCS supports the Commission's efforts to maintain fair and orderly markets. However, DBCS

evidence or regulatory precedent, is unduly onerous, will significantly limit the usefulness of the U.S. futures markets to international traders, and is premature in light of pending congressional legislation. [1] As such, the Proposal threatens to undermine the futures markets' advantages listed above.

The Proposal rests on the proposition that increased speculation leads to higher prices and volatility, yet provides no evidence for such a link. (In fact, the available evidence supports the opposite conclusion.) Second, the proposed regulatory intrusion into a liquid market is unprecedented. Furthermore, because the energy futures market is global, the excessive burden of the proposed regulations would, if enacted, drive many investors and traders to foreign exchanges, leaving the American markets thinner and therefore less liquid. The Proposal is also unnecessary. The nature of the futures markets and the operation of index funds themselves counteract the alleged dangers described by the Proposal. Not only are futures markets inherently balanced, but index funds help bring about the stability which the Commission seeks to accomplish through regulation. Moreover, compliance with the proposed method of account aggregation would be, at best, terrifically costly, and, at worst, impossible for a large financial holding company and its affiliates to administer. Finally, it is too early for the Commission to consider the Proposal, as legislation is currently pending in Congress to expand the Commission's authority over derivatives and impose cross-market position limits over both exchange-traded and over-the-counter derivatives.[2]

(1) The Proposal Lacks an Empirical Basis.

The assumption behind the proposed position limits is that the growth of commodity index funds is directly responsible for inflating prices, thereby creating a "speculative bubble." But the available empirical evidence, as compiled and analyzed by CFTC economists, other experts, and international regulators, does not support the existence of such a link. In fact, the evidence suggests that index fund activity has the opposite effect on the markets. A 2008 study by the CFTC, analyzing certain commodities markets over a six-month period from December 31, 2007 to June 30, 2008, determined that the price of crude oil went *down* as index fund activity in energy derivatives rose. *See* Commodity Futures Trading Commission, *Commodity Swap Dealers & Index Traders with Commission Recommendations* (Sep. 2008).[3] (This report found the same relationship

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[1] Also, the CFTC may be overstepping its authority by giving notice of these proposed regulations without making a specific finding. As the CFTC cites in the Proposal, section 4a(a) of the Commodity Exchange Act (the "Act" or "CEA") allows "the Commission, from time to time... [to] proclaim and fix such limits on the amounts of trading which may be done or positions which may be held... *as the Commission finds are necessary* to diminish, eliminate, or prevent [an undue and unnecessary burden on interstate commerce]." (emphasis added). The Act thus requires a specific finding that a rule is "necessary" before it may be proposed. Yet the Proposal does not contain such a finding. This omission is not merely a technical violation. Like the futures markets, the CFTC serves a vital role in the health of our economic system. But the benefits of this role depend partly on the shared belief among regulators, traders, and investors that the CFTC carefully follows fair and longstanding procedures under the Administrative Procedure Act of 1946 for the protection of all parties. There is no authority in the CEA for the CFTC to impose position limits for the purpose of preventing price movements resulting from large or concentrated positions. Taking forceful action in an arbitrary fashion is likely to diminish the general trust in the validity of commodity regulations.

[2] *See, e.g.,* Title III, the Derivatives Markets Transparency and Accountability Act of the Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Congress, 1st Session (2009).

[3] For example, on pages 22-23, the report states:

While the net notional value of commodity index business in NYMEX WTI crude oil increased sharply over the 6-month period ending on June 30, 2008—by about 30 percent, the actual numbers of equivalent long

report perceived no clear relationship at all.[5])

A broader view of the commodities markets bolsters the finding of the CFTC's report. A recent analysis based on data from the U.S. Energy Information Administration discovered that crude oil prices declined from 2006 to 2008 despite rising index investment. *See* Bob Greer, *Are Index Investors Driving Up Commodity Prices?*, p. 2 (May 2008). A similar conclusion has been reached by studies of index funds in the grain markets from 2004 to 2005. Market data for this period collected by the CFTC at the behest of the U.S. Senate Permanent Subcommittee on Investigations reveals that price levels remained largely unchanged, despite the dramatic increase in index fund positions during the same period. *See* Dwight R. Sanders and Scott H. Irwin, *Bubbles, Froth, and Facts: The Impact of Index Funds on Commodity Futures Prices*, pp. 10-11 (Feb. 2010).

These results in the energy and grain markets are the converse of what one would expect if escalating index investment led to escalating prices.[6] As the Chief Economist of the CFTC, Jeffrey Harris, testified before the U.S. Senate on May 19, 2008, "The absence of a link between fund positions and price changes suggests that global market fundamentals... provide a better explanation for the recent price increase."[7]

International regulators agree with the Chief Economist's interpretation. The Task Force on Commodity Futures Markets of the Technical Committee of the International Organization of Securities Commissions issued a report in March 2009 ("IOSCO Report"), analyzing the views of various global futures regulators. The IOSCO Report found that "the reports reviewed by the Task Force do not support the proposition that the activity of speculators has systematically driven commodity market cash or futures prices up or down on a sustained basis."[8]

Moreover, neither the business representatives who testified before the CFTC on July 28, 2009 in favor of stricter position limits nor the Proposal itself have provided the necessary evidence. The business representatives offered conjectural statements but no empirical data. They stated, for example, as cited in footnote 46 in the Proposal, "This increase in volatility has been *associated* with a massive increase in speculative investment in oil futures,"[9] and "Speculative trading

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futures contracts **declined** over that same period by about 11 percent. In other words, the sharp rise in the net notional value of commodity index business in crude oil futures appears to be due to an appreciation of the value of existing investments caused by the rise in crude oil prices and not the result of more money flowing into commodity index trading. (emphasis in original)

4 *Id.* at 27-28.

5 *Id.* at 24-25.

6 Indeed, as Bob Greer framed the issue on page 4 of his article cited directly above, "If there is any causality, it is the other way around. Rising commodity prices have caused an increased interest in commodity investment."

7 Jeffrey Harris, *Written Testimony before the Senate Committee on Homeland Security and Governmental Affairs* (May 20, 2008), *online at* http://hsgac.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=3fe95f08-0b7d-45d0-94ea-4c4346c353de.

8 Technical Committee of the International Organization of Securities Commissions, *Task Force on Commodity Futures Markets Final Report*, p. 7 (Mar. 2009) , *online at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD285.pdf.

9 Ben Hirst, Senior Vice President and General Counsel for Delta Airlines on behalf of the Air Transport Association of America, Inc., *Testimony before the Commodity Futures Trading Commission* (Jul. 28, 2009), *online at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/hearing072809_hirst.pdf.

CFTC in its Proposal described the ill effects of speculation and concentrated positions as hypothetical: "Large concentrated positions in the energy futures and option markets *can potentially* facilitate abrupt price movements and price distortions," and "Specifically, when large speculative positions are amassed in a contract, or contract month, *the potential exists* for unreasonable and abrupt price movements should the positions be traded out of or liquidated in a disorderly manner." (emphasis added). The possibility of dislocations always exists in any market. But the question for the CFTC, as the expert regulator, is not what is possible based on conjecture, but what is likely in light of specific findings.

In sum, it would appear that substantial evidence of a link between speculation and volatility or prices does not exist. Not only do the Proposal and its supporters fail to offer empirical evidence for the Proposal's underlying assumption, but the available evidence supports a contrary interpretation.

(2) The Proposal Lacks Regulatory Precedent.

No precedent in any commodity futures markets supports the Commission's proposal. The Commission's and the contract markets' position limit hedge exemption regimes have always allowed a single market participant to establish speculative positions up to the applicable position limits but also to obtain hedge exemptions, if the trading warrants it, for hedging positions above these levels. There is no reported history of market abuses that warrants the Commission's dramatically changing this longstanding policy for energy commodities.

(3) The Futures Market Is Unique Since Buyers Offset Sellers, Obviating the Need for Position Limit Restrictions.

The proposed position limits are superfluous because futures markets by their nature possess a fundamental balance not present in other markets. Commodities in futures markets do not have a finite number of contracts. If demand exists on either side of a future, another party can easily meet the other side of that demand, thereby quickly increasing or decreasing the open interest in that contract.

As a result the futures markets are essentially balanced - for every long there is an equal offsetting short position and for every short there is an equal offsetting long position. When cleared through the U.S. futures exchanges, the profits from one side are in equilibrium in every instance to the losses incurred by the other. Since losses are offset by gains, money is simply transferred from one account to the other and there is no net loss of wealth in either bull or bear markets. Accordingly, when speculators win, hedgers lose, and when hedgers win, speculators must lose.

(4) The Proposed Regulations Encumber the Free Market and Break Down the Efficiency of the Price Discovery Mechanism.

The futures exchanges allow for the creation of a free marketplace where willing buyers and willing sellers can come together to discover the price of the commodity that they are trading. Each time willing participants meet to buy and sell the commodities, they are engaging in the process of

[10] Laura Campbell, Assistant Manager of Energy Resources, Memphis Light, Gas & Water, on behalf of The American Public Gas Association, *Testimony before the Commodity Futures Trading Commission* (Jul. 28, 2009), *online at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/hearing072809_campbell.pdf.

constantly discovered in an open and transparent manner. However, onerous regulatory constraints imposed on market participants will impede them from transacting freely. As explained further below, these constraints are unusually onerous because they significantly interfere with risk offloading, price discovery, and diversification. The inevitable result will be less efficient markets and therefore more volatile commodity prices.

(5) The Proposed Position Limits Will Hinder the Ability of Individuals and Corporate Hedgers to Offload Risks.

A chief objective of the futures market is to provide individuals and companies who maintain price risk in their day-to-day business activities a place to offset those risks via hedging transactions. For example, the futures markets allows grain handlers to make commitments to buy or sell grain from and to their clients for months or years into the future. A deep and liquid futures market functions as a surrogate buyer or seller until an actual client can be found. Without the futures markets, the merchandisers would have no place to allay their risks of ownership on the long side, or to make a short position for a client who needs a long-dated sale. The futures markets exist to allow hedgers to hedge, a function only robust futures markets can accomplish.

(6) Position Limits Proposed by the CFTC Will Directly Inhibit Speculators' Ability to Take a View on Prices, Either Upwards or Downwards, and Consequently Will Severely Damage the Price Discovery Mechanism That Is the Modern Futures Market.

The futures markets also exist to allow speculators a forum to take a view on prices. Speculators are permitted to place their own money at risk if they so choose, and in the process of speculating (both long and short) they create liquidity that allows hedgers to easily hedge and the price of the underlying contract to be properly "discovered." But the proposed position limits, if passed, will prevent firms that are supposedly hedgers to take any positions other than perfect hedge positions and simultaneously prevent speculators from taking short positions unless they have a direct price risk of their own.

As a consequence, the proposed limits will significantly diminish liquidity, the lifeblood of efficient futures markets. If hedgers lose much of their ability to hedge, the currently transparent price discovery process will become opaque as speculators move to over-the-counter ("OTC") and overseas markets. Energy prices, rather than being continuously discovered by participants with real interests in the commodity in question and by speculators who wish to take an interest in that same commodity, each hoping to profit over the other, thereby promoting the price discovery function of the market itself, will be "skewed" by artificial and arbitrary constraints. U.S. futures markets, their efficiency crippled, will see significant thinning and increased volatility.

(7) Passive Index-Tracking Funds Should Be Exempt from Any Proposed and Existing Position Limits Since These Passive Investors (1) Do Not Impact the Supply and Demand of Commodities, (2) Are Heavy Net Sellers of Nearby Futures Contracts, (3) Do Not Speculate on Price Movements, and (4) Increase the Stability of the Markets.

It is a fundamental principle of the futures market that prices are set in the cash market by supply and demand for the actual physical commodities. However, passive index funds do not

consume any commodities.[11]

Further, passive index funds apply *zero* net buying pressure across the commodity term structure. As passive index funds cannot and do not hold positions into the delivery month, the primary market activity in which these unique market participants engage is the simple "rolling" of futures as they approach the spot month. This "rolling" occurs by selling nearby contracts and simultaneously buying an equal dollar amount of a more deferred contract. As the nexus of the cash and the futures market (at the near end of the futures curve), passive index funds are heavy net sellers as they sell their nearby current futures holdings in order to roll into more distant futures positions. Thus as futures contracts become deliverable to and converge with the physical market, index funds are no longer involved in those contracts and have no effect on the physical price determination process.

Additionally, passive index funds create a more liquid and efficient futures market for hedgers and speculators alike. Passive index tracking funds own futures contracts for the purpose of providing their underlying investors with portfolio diversification and inflation hedging. They do not take positions, short or long, in anticipation of future price movements. Often, the passive funds participate in illiquid contracts, thereby bringing liquidity where none existed.

Finally, passive index funds accomplish the same ends at which the Proposal aims. The Commission seeks to balance and calm the markets, but the markets are already more balanced and calmer because of the activities of passive index funds. They permit the small investor to gain access to and profit from the markets without suffering large risk. The funds are highly regulated, highly transparent, and fundamentally conservative in approach: they seek incremental growth and minimal loss through passive investing. In this fashion, the introduction of the small investor via passive index funds increases the market's capacity for risk-sharing.

Thus, the Commission's proposed rules should encourage, not limit, increased participation by index funds.

(8) Compliance with the Proposed Aggregation Rule Would Be Severely Costly and Perhaps Impossible.

The Proposal states that the proposed regulations "would aggregate positions in accounts at both the account owner and controller levels." Under this expanded scope, "eligible entities (such as mutual funds, commodity pool operators, and commodity trading advisors) and futures commission merchants will not be permitted to disaggregate positions pursuant to the independent account controller framework established in part 150 of the Commission's regulations." In other words, a firm will be obliged to aggregate positions across various divisions, no matter how numerous, how distant, or how independent those divisions may be. Current software would require radical reconfiguring, at great cost, to attempt to record and compile these various activities fast enough to satisfy the proposed regulation. Nor is it certain such an attempt would succeed.

[11] If the level of inventories rose with index investment, then, as Bob Greer put it on page 2 of his paper, cited *supra* page 3:

> the developed world would not be hostage to the Organization of the Petroleum Exporting Countries (OPEC). Any time we needed to increase crude inventories, we [could] merely... bring in more indexers, and the inventory would appear. In fact, the explanation for inventory levels of any commodity is much simpler. If, in the cash markets, production exceeds demand, inventories will rise. Otherwise, they will fall.

series of positions each near a proposed outer bound position limit without aggregation, may not be appropriate." This speculative statement begs the question whether the Proposal can be justified. Without a solid basis, the CFTC should not impose so costly a requirement.

Moreover, while the Commission has not offered evidence of the existence or likelihood of coordination among traders, the proposed solution will actually make such coordination more likely. Firms do not now have the software in place to coordinate the trading activities of their diverse and separate divisions. But the proposed regulation will require them to develop this software. In other words, while coordination among divisions does not appear to exist at present, the "solution" may facilitate such coordination.

(9) Aggregation Rules Should Be Modernized.

The Proposal does not address the crucial issue of aggregation of energy and other commodity positions amongst entities that are under common control. The Commission should adopt an aggregation rule that is responsive to the legitimate trading and risk management needs of financial holding companies that have numerous affiliates and trading desks, each of which independently trade in the futures markets. The CPOs of commodity pools and index-tracking commodity pools, as well as issuers of commodity-indexed notes, are often separate business units of a multifaceted financial institution that have implemented appropriate barriers between the units. We encourage the Commission to consider adopting a responsible aggregation rule for a multifaceted financial institution. In this regard, we recommend that the Commission amend Regulation 150.3(a)(5) (or add a new section to proposed part 151) to responsibly disaggregate a financial holding company's affiliates' positions, as follows.

"**Proposed Rule 150.3(a)(5) – Aggregation Exemption for Financial Institutions**

(a) Positions which may exceed limits. The position limits set forth in § 150.2 and § 151.2 of this part may be exceeded to the extent such positions are:

* * *

(5) Financial Institution.

(i) Carried by (a) an Independent Trading Unit (as defined herein) of a financial institution (as defined in section 1a(15) of the Act) in the separate account or accounts of the financial institution controlled by an Independent Trading Unit of the financial institution or (b) any commodity pool organized as a separate legal entity or separate series of a separate legal entity where trading is controlled by such Independent Trading Unit, in each case where each Independent Trading Unit of the financial institution has, and enforces, written procedures to preclude other Independent Trading Units from having knowledge of, gaining access to, or receiving data about, trades of the other ("Disaggregation Procedures"). Such Disaggregation Procedures must include document routing and other procedures or security arrangements, including separate physical locations, which would maintain the independence of their activities; *provided, however,* that such Disaggregation Procedures may provide for the disclosure of information which is reasonably necessary for a financial institution to maintain the level of control consistent with its fiduciary responsibilities and necessary to fulfill its duty to supervise diligently the trading done on its behalf or through the Independent Trading Units, including

and supervisory personnel that may be common to all Independent Trading Units. The financial institution must file with the Commission a notice of eligibility that:

(a) describes and confirms the implementation of the Disaggregation Procedures;

(b) designates an office of the financial institution responsible to coordinate the Disaggregation Procedures;

(c) provides an organizational chart that includes the name, main business address, main business telephone number, main facsimile number and main email address of the financial institution, each Independent Trading Unit, and if applicable, any separate legal entity whose trading is controlled by such Independent Trading Unit;

(d) provides the names of pertinent staff of each Independent Trading Unit (trading, operations, compliance, clerical, and risk management) and their work locations;

(e) provides a description of all information sharing systems, bulletin boards, and common email addresses;

(f) provides an explanation of the financial institution's risk management system and staff structure and a description of the overall structure and operations of the relevant staff;

(g) provides an explanation of how and to whom the trade data and position information is distributed for each Independent Trading Unit, including which officers receive reports for all Independent Trading Units and their respective titles; and

(h) is signed by a representative duly authorized to bind the financial institution.

As used in this rule, the term "Independent Trading Unit" means a branch, office, profit center, affiliated commodity pool operator, passive commodity pool tracking an index, or affiliate of the financial institution that complies with the Disaggregation Procedures and is listed in the notice of eligibility.

(ii) The notice of eligibility will be effective upon filing, provided the notice is materially complete. The notice of eligibility must be refiled within 45 days of January 1 of each year following the initial filing."

* * *

B. **Responses to Commission's Questions.**

In response to several of the questions posed in Appendix A, below are the questions and our responses.

reporting markets necessary to "diminish, eliminate, or prevent" the burdens on interstate commerce that may result from position concentrations in such contracts?

Response. No, it is not necessary for the Commission (a) to apply federal speculative position limits concurrently with existing exchange-set position limits and position accountability requirements or (b) to create an aggregate set of limits that would apply to similar futures contracts across markets. The fear of "burdens on interstate commerce" is misplaced. Greater speculative investment does not lead to inflated prices or higher volatility. As such, the suggested regulations would not serve their declared purpose.

As explained in detail in the general comments above, the Proposal contains no empirical evidence of the supposed connection between increased speculation and higher prices or volatility. Furthermore, the data available from other sources, including the CFTC's own research, does not support such a connection. Without any cause-and-effect relationship, the proposed regulations will not prevent price spikes. Rather, just as contracts in the agricultural markets suffered unusually high prices in 2007-08 in the face of position limits, prices will rise and fall based on factors other than those addressed by the Proposal.

Because the solution devised is unnecessary and ineffectual, it will succeed only in constraining a popular investment vehicle that improves the stability of the futures markets.

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

Response. The Commission's aggregation regime must be modernized to prudently apply the limits to passive index-tracking CPOs who use the futures markets for legitimate risk management purposes, in a manner that does not penalize those CPOs who operate multiple commodity pools, each a separate legal entity, each having its own public investor beneficial owners, each tracking a different index. Imposing Federal speculative position limits without also adopting a realistic aggregation policy that permits responsible traders, such as a regulated CPO, to trade in these markets without the positions in one of its pools being aggregated with those of its other pools, will decrease liquidity and impair price discovery, causing pools to move their trading to foreign markets. The Commission should adopt an aggregation rule that disaggregates the positions of highly regulated passive index-tracking commodity pools from other pools that either (a) are operated by the same CPO or (b) track the same index, where there is either no common control or no common ownership among the investors that own 10% or more of the pools.

Additionally, rather than imposing strict limits, the Commission should consider adopting "position accountability" standards similar to those administered by futures exchanges as required under Appendix B to Part 38 of the Commission's regulations. Position accountability, rather than position limits, would permit the Commission to require traders who own or control positions in excess of certain thresholds to provide the Commission, upon request, with information regarding the nature of the positions, hedging needs, and the trading strategy to enable the Commission to determine at that time the appropriate course of action, rather than arbitrarily imposing limits on all traders.

Finally, if the Commission does adopt Federal speculative position limits, the different exchanges should either withdraw their position accountability and position limits regimes in

will apply across exchanges.

Question 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?

Response. The exchanges currently set position limits for the last three trading days before the delivery period and accountability levels for energy commodities. If Federal position limits replace or supersede exchange-set accountability levels for energy and other commodities of finite supply, the integrity of the price discovery process will be compromised. Fixing a position limit solely for U.S. energy futures trading will cause traders seeking additional commodity price exposure to shift to foreign exchanges or OTC markets, thus avoiding exposure to the impact of the proposed rules. As more market participants shift to these other, less transparent markets, the focal point for price discovery will also shift.

Question 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 sub-group of contracts within a class be treated during the spot month for the purposes of enforcing the proposed speculative position limits?

Response. These should also be treated as separate given different settlement prices.

Question 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.

Response. Under the proposed rules, the all-month limit ("AML") for each of the four energy commodities approaches 2.5% of open interest as open interest increases. Thus the rationale behind the 25,000 threshold is weak and needlessly complex.

A simpler solution would be to fix the percentage of open interest. As open interest grows, so does the AML. We think the rule for passive speculators should be 10% (thus requiring at minimum 10 aggregators in the market) and for non-aggregators/speculators it should be 5% (thus requiring at minimum 20 speculators in the market). Given the size of the energy markets (large number of participants) the CFTC's concerns should be addressed by these limits. (We note that each of the limits we propose are as arbitrary as the 2.5% limit and the 25k OI threshold proposed by the CFTC.)

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..."

Response. No, speculative limits should not be based on position sizes customarily held by speculative traders in that contract market. The futures market is not a "one size fits all" market. Speculators in the futures markets have vastly divergent trading strategies and goals. Some speculators invest based on their view of future market movements. Others, such as passively managed index tracking ETFs, invest to provide their underlying investors with access to the markets without the inherent complexities and risks of directly investing in futures (e.g., margin requirements, clearing issues, diversification, and position limit monitoring). Given the diversity of participants, basing AML on the customary size of speculators will serve to permit a more homogenous set of market participants, which could potentially lead to less liquid and more volatile markets.

Question 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.

Response. The Commission's speculative position limits should preempt self-regulatory organization ("SRO") accountability limits. Currently, in the absence of speculative limits in the energy complex, accountability limits are imposed by SROs to ensure that no single market participant achieves a large percentage of the open interest in a particular contract. Should position limits rooted in open interest be imposed by the CFTC, accountability limits would be redundant (as they would serve the same function as the speculative limits), (2) add costs to all parties (including CFTC, SROs, investors, CTAs, CPOs), and (3) add unnecessary regulatory complexity.

Position accountability rules and position limits maintained by the exchanges should be explicitly limited to speculative positions. Positions traded for risk management purposes in respect of a passive index-tracking fund should be explicitly excluded from these requirements.

Question 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.

Response. In a departure from the current rule 150.3(a)(4) aggregation regime for agricultural products, commodity pool operators, mutual funds and certain CFTC registrants (each an "eligible entity") would not be permitted to disaggregate energy positions that are traded on their

positions traded by IACs for collective investment vehicles are disaggregated under part 150. In departing from this established procedure, under the Proposal, energy position limits would be applied to all positions in which a person has a direct or indirect ownership of 10% or greater, or 25% or greater in a commodity pool.

The Proposal would aggregate the positions in accounts in which any person has an ownership or equity interest of 10% or more, or with respect to which such person controls the trading. As a result, the Proposal would aggregate positions in accounts at both the account owner and control level for energy commodities, in addition to eliminating the IAC exemption for position limits that currently exists in Regulation 150.3(a)(4). With respect to commodity pools, energy position limits would be applied to all positions in which any person has a direct or indirect ownership or equity interest of 10% or greater, subject to an exemption for a passive limited partner or shareholder ("pool participant") having less than a 25% ownership interest of a commodity pool. Under proposed rule 150.4(b), the pool participant need not aggregate the pool's energy positions with its other positions. We urge the Commission to clarify that although a pool participant having greater than 25% ownership of a commodity pool must aggregate the pool's energy positions with the pool participant's positions, proposed rule 150.4(b) is not intended to require the commodity pool to aggregate the participant's energy positions with those of the pool, *i.e.*, one-way aggregation is the intent of the Proposal. Requiring a commodity pool to aggregate its pool participant's positions with those of the pool would result in a pool's trading ability being limited by the independent trading of its pool participants whom it does not control, and create an ongoing unnecessary due diligence and operational burden for CPOs.

We urge the CFTC to retain the IAC exemption as it currently exists in Regulation 150.3(a)(4) and its applicability to energy commodities. The IAC exemption is premised on the fact that accounts that are under separate management need not be aggregated because they have no combined effect on the market. The elimination of the IAC exemption is unnecessary and will be disruptive to a wide variety of market participants that have relied upon the exemption to operate efficiently in the commodity markets.

The Proposal will also require holding company structures that have separate business units trading for various proprietary and customer accounts to aggregate their holdings across their various business units. The Proposal is not operationally feasible for large financial institutions and will have the unintended consequence of requiring organizations that have not shared information in the past to disclose their positions to other independent business units.[12]

Question 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?

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[12] The Proposal is also inconsistent with the approach taken by the SEC under the Securities Exchange Act of 1934. The SEC permits the parent holding company of qualified institutional investors to disaggregate the holdings of its various business units if there are appropriate informational barriers between the business units for purposes of Section 13(d) and (g) and Section 16(a) reporting requirements. *See* Amendments to Beneficial Ownership Reporting Requirements, Exchange Act Release No. 34-39538, 63 Fed. Reg. 2854, at 2857-8 (Jan. 12, 1998).

regulated contracts. FBOT contracts generally have different terms and characteristics even if the underlier is similar to a CFTC-regulated contract.

Question 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. The Commission seeks comment on how it should take this pending legislation into account in proposing Federal speculative position limits.

Response. We recommend that the Commission wait until final OTC derivatives legislation, such as Title III of H.R. 4173, is enacted before proposing Federal speculative position limits. As the final legislation may differ from the pending legislation, it may be futile at this time to anticipate how to coordinate exchange-traded futures limits with OTC derivatives position limits.

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

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?

Response. No, the Commission should not make the rules unnecessarily complex. Complex rules that are not warranted by market conditions will cause traders to seek other markets outside of the U.S. Rolling averages or more frequent averages are an extreme response to what appears to be a phantom problem.

Question 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.

Response. Passive, unleveraged long-only index-tracking trading strategies used by many publicly-traded commodity pools, as well as by index tracking pools that are leveraged and/or also take short positions (each a "Passive Pool"), can be distinguished from actively managed commodity pools. A Passive Pool is not a "speculator" within the intent of Commission Regulation 1.3(z). A Passive Pool's investment objective is simply to track an index over time, regardless of whether the index is rising, falling or flat. To that end, a Passive Pool acquires long futures positions in the commodities making up the underlying index. Because a Passive Pool is not an actively managed pool, it does not utilize a discretionary trading program or any other investment or trading methodology.

Regulation 1.3(z) provides in relevant part that hedging transactions "are economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise." A Passive Pool's only objective is to track the underlying index over time (through acquiring long futures positions), using a nondiscretionary methodology. A Passive Pool should be viewed as

futures positions in the underlying index commodities, with no intent to speculate in the futures market, therefore presenting no danger of excessive speculation that may cause harmful fluctuations in commodity prices.

Under Section 4a(c) of the CEA, the Commission must exempt "bona fide hedging transactions" from its position limits. Yet this requirement does not forbid other exemptions as well. The CEA gives the Commission flexibility in this area to mold appropriate exemptions for traders found not to have engaged in commodity speculation. The Commission could adopt an exemption from speculative position limits for Passive Pools.

The Commission staff granted, but then three years later rescinded, no-action relief to two passive long index-based funds from speculative position limits on certain agricultural commodities. *See* CFTC Letter 06-09 (April 19, 2006); CFTC Letter 06-19 (September 6, 2006). The no-action letters provide guidance in establishing an exemption for Passive Pools. In 2009, the Commission staff affirmatively determined that these funds "represented a legitimate and potentially useful investment strategy." 74 Federal Register 12282 (CFTC, March 24, 2009), at footnote 15.

As stated in the no-action letters, Passive Pools include the following attributes: (i) passive tracking of a benchmark; (ii) excess positions not affecting the spot month futures contract; (iii) high level of transparency; (iv) extensive federal and self-regulatory oversight; and (v) lack of price exposure to the fund. *See* CFTC Letter 06-09 at 4; CFTC Letter 06-19 at 5-6.

These unique features of Passive Pools allow them to actively participate in the commodity futures market while still providing substantial protections and full disclosure to market participants and the investing public. Their activities do not cause the concerns that Federal position limits are intended to address. Additionally, limiting the ability of Passive Pools to trade in the futures markets will: (i) expose retail passive investor customers to bilateral credit risks; (ii) increase price volatility and reduce liquidity; and (iii) force more retail customers to access the futures markets directly. We believe that the Commission should codify rules exempting Passive Pools from speculative position limits or adopt a separate position limits exemption for Passive Pools.

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

Response. Notwithstanding the public hearings conducted in 2009 by the Commission, there is no published empirical data evidencing that trading by passive long traders has caused any harmful energy price movements, as discussed in the general comments above.[13] We believe that the Commission does not need to issue explicit regulations to limit positions of passive long traders such as Passive Pools, as Passive Pools are not traditional speculators. The Commission should recognize the index-tracking strategies of passive long traders, as opposed to actively managed trading strategies. Because a Passive Pool long trader that tracks an index cannot form the intent to manipulate the market or cause harmful fluctuations in commodity prices, and because it tracks an

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[13] To the contrary, passive investors may have beneficial effects on futures markets, by decreasing volatility and improving non-spot month liquidity. *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 (Aug. 2009), *online at* http://purl.umn.edu/53083. *See also* Philip K. Verleger, *Notes at the Margin* (Jan. 11, 2010), *online at* http://www.pkverlegerllc.com/nam100111.pdf.

management in the pool, rather than a strict numerical limit. Larger Passive Pools should have higher limits. Prior actions by the Commission in respect of passive long traders have reportedly caused one large pool to reduce its futures holdings and utilize more expensive and less transparent OTC derivatives as an alternative, also resulting in potentially increased tracking errors relative to the benchmark futures prices. *See* "UNG Fund Cuts Natgas Position Due to CFTC Moves" (Reuters, July 29, 2009). Presumably, the OTC swap dealer used by the pool will in turn simply hedge its exposure through the use of futures, resulting in the same positions' being traded, albeit by the dealer rather than the pool. To avoid adversely affecting a pool's public retail investors, we recommend that the Commission refrain from adopting constrictive, arbitrary position limits for passive long traders. We encourage the Commission to create an exemptive process for passive long traders similar to the proposed swap dealer risk management exemption.

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

Response. Most Passive Pools are passive long traders, as is evident from a review of their disclosure documents. The Commission could consider having such Pools file a certificate with the Commission confirming their status as an "Index-tracking Exchange-traded Pool (or ITETP)," and apply speculative position limit and aggregation rules and exemptions applicable to these uniquely transparent and highly regulated collective investment vehicles.

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?

Response. Passive long traders, such as Passive Pools, should be permitted to trade pursuant to a "passive long trading exemption" similar to the Commission's proposed swap dealer risk management exemption, requiring appropriate filing with the Commission. This will facilitate liquidity in the markets rather than force these traders to seek alternatives such as OTC swap transactions or foreign futures markets.

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?

Response. No. Market space should be apportioned to each fund according to each fund's own merits.

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

Response. Such unintended consequences include (a) removing from the market a significant source of liquidity, (b) disenfranchising the thousands of public retail investors who invest in Passive Pools as a mechanism to prudently access these markets as a diversification and hedging tool, (c) preventing the passive long trader's affiliated commodity pools, if subject to aggregation, from using the futures markets, (d) causing these traders to utilize OTC derivatives and foreign markets as alternatives, which are less transparent and less regulated markets, (e) increasing price volatility and distortion of price discovery signals and (f) leaving foreign markets as the focal points for commodity price discovery.

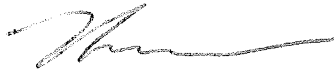
index, and contracts of the same class are intended to be simple definitions that readily identify the affected contracts through an objective and administerial process without relying on the Commission's exercise of discretion.

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

Response. "Diversified" should mean more than four underlying contracts, none of whose target index base weights is greater than 50% of the fund's index.

DBCS thanks the Commission for the opportunity to submit this comment letter. Please do not hesitate to contact the undersigned or our outside counsel, Michael Sackheim of Sidley Austin LLP at (212) 839-5503 if you would like to discuss our comments.

Respectfully submitted,



Hans Ephraimson, Chief Executive Officer

cc: Michael S. Sackheim