From: Sweeney, R. Michael <rsweeney@hunton.com>
Sent: Monday, April 26, 2010 4:42 PM
To: secretary <secretary@CFTC.gov>
Cc: McIndoe, David <dmcindoe@hunton.com>; Menezes, Mark W. <mmenezes@hunton.com>; Holtan, Alexander S. <AHoltan@hunton.com>
Subject: Notice of Proposed Rulemaking, Comment File No. 10-002 - 17 C.F.R. Parts 1, 20 and 151 Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations
Attach: cftc position limits nopr comments (final)_(30584013)_(1).pdf; Sweeney, R. Michael.vcf

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Dear Secretary Stawick:

On behalf of the Working Group of Commercial Energy Firms (the "Working Group"), Hunton & Williams LLP hereby submits the attached comments in response to the request for public comment set forth in the Notice of Proposed Rulemaking issued by the Commodity Futures Trading Commission and published in the *Federal Register* on January 26, 2010, addressing whether federal speculative position limits should be imposed for certain referenced energy contracts and amending associated regulations set forth in Title 17 Chapter I of the Code of Federal Regulations. *See Federal Speculative Limits for Referenced Energy Contracts and Associated Regulations,* Notice of Proposed Rulemaking, 75 Fed. Reg. 4144 (Jan. 26, 2010).

The Working Group appreciates this opportunity to comment, and requests that the Commission consider these comments as it develops a final rule in this proceeding.

Respectfully Submitted,

R. Michael Sweeney, Jr. **
David T. McIndoe
Mark W. Menezes

Counsel for the Working Group of Commercial Energy Firms

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** - Designated for service:

R. Michael Sweeney, Jr.
Hunton & Williams LLP
1900 K Street, N.W.
Suite 1200
Washington, D.C. 20006
(202) 955-1500
rsweeney@hunton.com

R. MICHAEL SWEENEY, JR.

HUNTON & WILLIAMS LLP

1900 K Street, N.W.

Suite 1200

Washington, D.C.

(202) 955-1944

rsweeney@hunton.com

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HUNTON & WILLIAMS LLP
1900 K STREET, N.W.
WASHINGTON, D.C. 20006-1109

TEL 202 • 955 • 1500
FAX 202 • 778 • 2201

FILE NO: 76142.2

April 26, 2010

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

VIA ELECTRONIC MAIL

Re: *Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations*, Comment File No. 10-002

Dear Secretary Stawick:

I. INTRODUCTION.

On behalf of the Working Group of Commercial Energy Firms (the "Working Group"), Hunton & Williams LLP submits the following in response to the request for public comment set forth in the Notice of Proposed Rulemaking ("NOPR") issued by the Commodity Futures Trading Commission ("CFTC" or "Commission") and published in the *Federal Register* on January 26, 2010,[1] proposing to implement federal speculative position limits for futures and options for the following four (4) major energy commodities:

- Henry Hub Natural Gas;
- Light Sweet Crude Oil (a/k/a West Texas Intermediate or WTI);
- New York Harbor No. 2 Heating Oil; and
- New York Harbor Gasoline Blendstock.[2]

The Working Group is a diverse group of commercial firms in the energy industry whose primary business activity is the physical delivery of one or more energy commodities to customers, including industrial, commercial and residential consumers (each, an "Energy

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[1] *See Federal Speculative Limits for Referenced Energy Contracts and Associated Regulations,* Notice of Proposed Rulemaking, 75 Fed. Reg. 4144 (Jan. 26, 2010).

[2] Each a "Referenced Energy Contract" and collectively, these commodities referred to herein as the "Referenced Energy Contracts."

Provider"). Members of the Working Group are energy producers, marketers and utilities. The Working Group considers and responds to requests for public comment regarding legislative and regulatory developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

II. EXECUTIVE SUMMARY.

1. The instant proceeding should be stayed until the pending Congressional debate regarding proposed legislation to reform the regulation of over-the-counter ("OTC") derivatives markets is settled. Staying this proceeding will ensure that the framework for imposing federal speculative position limits for the Referenced Energy Contracts is consistent with the requirements of such legislation. This will also avoid a situation in which market participants must comply with a regulatory framework that may change materially upon the enactment of OTC derivatives reform legislation. Should, however, the Commission issue a final rule, an adequate period of time should be provided prior to its effective date allowing market participants to implement appropriate compliance measures.

2. The "crowding out" provisions of the proposed *bona fide* hedge exemptions are not necessary to meet the policy objective of Section 4a of the Commodity Exchange Act ("CEA") and are not adequately justified. As discussed in Sections III.A.1 & A.2, these provisions (i) will decrease liquidity in energy markets, and (ii) will unnecessarily prohibit commercial market participants relying on hedge exemptions from engaging in any speculative trading activity.

3. The aggregation policy in proposed Section 151.4(a) of the CFTC's regulations requires clarification or amendment to include necessary exemptions. As noted in Section III.A.3, absent such clarification or amendment, Section 151.4(a) will have (i) a significant and chilling impact on future investment in the energy sector, and (ii) the unintended consequence of resulting in violations of certain other federal and state regulatory requirements applicable to Energy Providers.

4. As discussed in Section III.A.4, the deliverable supply methodology adopted by the Commission must be (i) clear and transparent to all market participants, (ii) flexible enough to adapt to the continuing evolution and growth of markets for the Referenced Energy Contracts, and (iii) subject to periodic review at regularly scheduled intervals to ensure that the methodology is updated as necessary.

5. The proposed definition of "swap dealer" is overly broad. This definition, however, can be properly tailored with some modification. As discussed in Section III.A.5, the definition of "swap dealer" must encompass all market participants commonly understood to be dealers, but it should not be so expansive that it inadvertently captures commercial Energy Providers.

III. COMMENTS OF THE WORKING GROUP.

A. GENERAL COMMENTS.

If properly designed and implemented consistent with the CFTC's existing authority under the CEA,[3] federal speculative position limits on the Referenced Energy Contracts will not unnecessarily disrupt today's highly efficient energy markets. However, the Working Group respectfully submits that the public interest will be best served if the Commission stayed this proceeding until the pending Congressional debate regarding proposed legislation to reform the regulation of OTC derivatives markets is settled.[4] If enacted, such legislation will almost certainly include material amendments to the CEA, and is likely to include a provision that addresses the Commission's authority to impose position limits under Section 4a.[5]

Similar to other commenters in this proceeding,[6] the Working Group is concerned that market participants will expend considerable time and resources to comply with new federal speculative position limits for the Referenced Energy Contracts, only to be forced to reconstruct their compliance program if Congress enacts OTC derivatives reform legislation with position limit provisions that differ from rules adopted by the Commission in this proceeding.[7] Staying this proceeding will ensure that the framework for imposing federal speculative position limits for Referenced Energy Contracts is consistent with such legislation. It will also avoid a potentially wasteful and costly situation in which market participants are forced to comply with a position limit framework that may change materially in the near future as a result of pending Congressional action. Allowing the legislative process to run its course will not unduly limit the Commission's ability to meet its stated goal of using federal speculative position limits to

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[3] 7 U.S.C.§§ 1 *et seq.*

[4] On December 11, 2009, the House of Representatives passed the "Wall Street Reform and Consumer Protection Act of 2009" (H.R. 4173). H.R. 4173 was passed as comprehensive financial regulatory reform legislation. Title III of H.R. 4173 specifically addresses proposed reforms to the regulation of markets for OTC derivatives. On March 22, 2010, the Senate Banking Committee passed a comprehensive financial regulatory reform bill ("S. 3217"). Title VII of S. 3217 specifically addresses proposed reforms to OTC derivatives markets. In addition, the Senate Agriculture passed stand-alone legislation to reform regulation of OTC derivatives markets on April 21, 2010.

[5] 7 U.S.C. § 6a.

[6] *See* Comments of the Futures Industry Association, Proposed Federal Speculative Limits for Referenced Energy Contracts and Associated Regulations, dated March 18, 2010 ("*FIA Comments*").

[7] Specifically, the approach proposed in H.R. 4173 for imposing position limits in markets for OTC derivatives is distinctly different than the Commission's existing authority under CEA Section 4a(a). For example, H.R. 4173 would provide the Commission with authority to impose position limits for swaps in physical commodities markets that are either (i) deemed to be economically equivalent to futures or (ii) that perform a significant price discovery function. *See* H.R. 4173, § 3113. Moreover, H.R. 4173 proposes to amend the CEA for purposes of revising the existing framework upon which the Commission sets position limits (*i.e.,* it would permit the imposition of position limits for a commodity on an aggregate, across market basis) and implementing exemptions applicable to *bona fide* hedgers and swap dealers. *Id.*

"diminish, eliminate, or prevent excessive speculation causing sudden or unreasonable fluctuations in the price of a commodity or unwarranted changes in the price of a commodity."[8]

The Commission possesses adequate statutory authority under the CEA to protect market participants from manipulation and to monitor for excessive speculation. The Commission should commit its resources to those ends. Specifically, the Commission can combat manipulation and excessive speculation through the use of several existing enforcement and surveillance tools, including its (i) Large Trader Reporting System,[9] (ii) special call authority,[10] and (iii) general compliance oversight of designated contract markets ("DCMs") and significant price discovery contracts ("SPDCs") traded on exempt commercial markets ("ECMs").[11] In addition to its current enforcement and surveillance activities, the Commission could develop alternative measures, such as its own position accountability rules, to enhance its ability to effectively survey and police these markets.[12] However, should the Commission decide to issue a final rule in this proceeding, the Working Group respectfully submits that it provide an adequate period of time prior to the effective date of the rule to allow market participants to design, implement and test modifications to their trading systems to account for the federal speculative position limits.

Finally, the Working Group agrees with the Commission's interpretation that the CEA does not provide the Commission with the authority to impose position limits on derivatives executed in the OTC markets.[13] If Congress does provide the Commission with expanded

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8 NOPR at 4145.

9 17 C.F.R. § 18 (2009).

10 *See* 7 U.S.C. § 3(b), 17 C.F.R. §§ 18 & 21 (special call authority for non-exempt markets); 7 U.S.C. § 3(b), 17 C.F.R. § 2(h)(5)(B)(iii), 17 C.F.R. § 36.3(b)(5) (special call authority applicable to SPDCs traded on ECMs).

11 7 U.S.C. § 7 (addressing CFTC compliance oversight of DCMs); 7 U.S.C. § 2(h) (addressing CFTC compliance oversight of SPDCs traded on ECMs).

12 Such measures could be readily incorporated into the set of core compliance principles applicable to DCMs and SPDCs traded on ECMs. *See* 7 U.S.C. § 5d, 17 C.F.R. §38, Appendix B (addressing compliance with core principles for DCMs), and 7 U.S.C. § 2(h)(7)(C), 17 C.F.R. § 36, Appendix B (addressing compliance with core principles applicable to SPDCs traded on ECMs).

13 NOPR at 4163. CEA Section 4a(a), 7 U.S.C. § 6a(a), makes clear that the Commission's existing authority to impose federal speculative position limits is limited to futures and options contracts traded on DCMs and SPDCs traded on ECMs. In relevant part, CEA Section 4a(a) states:

> Excessive speculation in any commodity under *contracts of sale of such commodity for future delivery made on or subject to the rules of contract markets or derivatives transaction execution facilities, or on electronic trading facilities with respect to a significant price discovery contract* causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity, is an undue and unnecessary burden on interstate commerce in such commodity.

. . . .

authority under the CEA over OTC derivatives markets, it is imperative that the Commission regulate such markets with a high degree of care and restraint.

1. Proposed Limitations on *Bona Fide* Hedge Exemptions.

a. The Proposed "Crowding Out" Provisions Will Disrupt Energy Markets and Violate the CEA.

If the Commission accepts as a premise for *bona fide* hedge exemptions proposed in the NOPR that hedges are not speculative, then hedges should not reduce the ability of commercial market participants or swap dealers to engage in speculative transactions. To do so would equate hedging transactions with speculative transactions. Section 4a of the CEA does not provide the Commission with the authority to assert this equivalency merely because an entity holding *bona fide* hedge positions also engages in limited speculative trading activity.[14]

The "crowding out" provisions applicable to *bona fide* hedge exemptions proposed in the NOPR will disrupt energy markets by decreasing liquidity and unnecessarily prohibiting commercial market participants that rely on such exemptions, including Energy Providers, from engaging in meaningful price discovery or other speculative trading activity. As proposed, the NOPR would effectively cap the number of positions for both *bona fide* hedges and speculative positions. This result is (i) contrary to the Commission's express recognition of the important

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> For the purpose of diminishing, eliminating, or preventing such burden, the Commission shall, from time to time, after due notice and opportunity for hearing, by rule, regulation, or order, proclaim and fix such limits on the amounts of trading which may be done or positions which may be held by any person under *contracts of sale of such commodity for future delivery on or subject to the rules of any contract market or derivatives transaction execution facility, or on an electronic trading facility with respect to a significant price discovery contract*, as the Commission finds are necessary to diminish, eliminate, or prevent such burden.
>
> (Emphasis added).

See also Closing Statement of Commissioner Michael V. Dunn, *Hearings on Position Limits and Hedge Exemptions* (Aug. 5, 2009)(" it is clear to me that the CFTC does not have the authority to set speculative position limits in all of the venues that may be affected by excessive speculation, specifically over-the-counter markets (OTC) and on foreign boards of trade (FBOT).")

[14] *See* 7 U.S.C. § 4a(c). CEA Section 4a(c) states that, "[n]o rule, regulation, or order issues under subsection (a) of this section shall apply to transactions or positions which are shown to be *bona fide* hedging transactions or positions . . ." The Working Group agrees with the arguments of other commenters that counting a market participant's *bona fide* hedge positions against an applicable speculative position limit is inconsistent with the clear language of CEA Section 4a(c). *FIA Comments* at 22.

role that speculation plays in energy markets and (ii) inconsistent with existing rules limiting speculative positions in agricultural markets.[15]

For instance, the NOPR states that the Commission's experience imposing position limits in agricultural markets provides a relevant framework for imposing position limits in energy markets.[16] Under the Commission's existing regulations, entities transacting in agricultural markets may engage without restriction in speculative transactions up to the limit set for a particular commodity and concurrently engage in *bona fide* hedge transactions in the same commodity up to their approved hedge exemption limit.[17] However, the "crowding out" provisions proposed in the NOPR for the Referenced Energy Contracts deviate significantly from the framework used for *bona fide* hedge exemptions in agricultural markets.

Specifically, the "crowding out" provisions are structured as cliffs. Under this structure, a trader that is one contract over a designated position limit for a Referenced Energy Contract is prohibited from holding a speculative position in the same contract.[18] The resulting market disruption will increase volatility which, in turn, will likely result in consumers paying relatively higher prices for the physical commodities underlying the Referenced Energy Contracts.

The "crowding out" provisions of the proposed hedge exemptions for Referenced Energy Contracts are not necessary to meet the policy objective of CEA Section 4a, which is to prevent excessive speculation. The Commission has not shown that the proposed "crowding out" provisions are necessary to prevent the burdens of excessive speculation as required under CEA Section 4a, let alone justify the significant compliance burden and risk to market participants.[19] Instead, despite the potential disruption to both financial and physical energy markets, the NOPR merely states that these provisions would "would restrict a trader controlling large positions used for hedging from also entering into large speculative positions or large swap dealer risk management."[20]

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[15] *See Commodity Futures Trading Commission*, HEARINGS ON POSITION LIMITS AND HEDGE EXEMPTIONS, official transcript, page 41, lines 12-13 (quoting CFTC Chairman Gary Gensler that "speculators are a very important part of the functioning markets. . .") (July 29, 2009); *see also Commodity Futures Trading Commission*, STAFF REPORT ON COMMODITY SWAP DEALERS & INDEX TRADERS WITH COMMISSION RECOMMENDATIONS, Appendix C at 39 (Sept. 2008)(noting that speculators serve important market functions, such as immediacy of execution, liquidity, and information aggregation).

[16] NOPR at 4149.

[17] 17 C.F.R. § 150.3

[18] For example, if an Energy Provider maintains a 5,000 contract position in a Referenced Energy Contract pursuant to a valid and effective *bona fide* hedge exemption and the established federal speculative limit is set at 3,000 contracts, the Working Group does not believe that if the same Energy Provider held one speculative contract in addition to its *bona fide* hedge positions for a total of 5,001 contracts, the Energy Provider would be engaging in "excessive speculation."

[19] *See* discussion in Section III.A.2.

[20] NOPR at 4159.

b. The "Crowding Out" Provisions Makes Compliance with the Proposed *Bona Fide* Hedge Exemptions Problematic.

Given the real-time, dynamic nature of energy markets, the proposed cliff structure of the "crowding out" provisions creates a rigid compliance obligation that is essentially impossible to meet. However, the consequences for non-compliance are significant. As proposed in the NOPR, it would be a *violation of the CEA - a federal statute* - for a trader using a *bona fide* hedge exemption to have as little as one contract deemed to be speculative. Specifically, the lack of flexibility associated with this structure unnecessarily increases the exposure of market participants to the risk of inadvertent violations of position limits applicable to Referenced Energy Contracts. A position put on in good faith as a *bona fide* hedge may become speculative for exogenous reasons that are beyond a party's control.

For example in the natural gas industry, Energy Providers' load serving obligations can vary materially from projected estimates due to the occurrence of certain unforeseen events.[21] An Energy Provider's position to hedge its physical delivery gas obligations to commercial and industrial customers could appear to be speculative due to (i) a significant reduction in demand resulting from a severe downturn in the national or regional economy or (ii) a loss of load due to the outcome of a competitive procurement process or natural disaster. Similarly, in the oil industry, a market participant may put on positions to hedge the anticipated delivery of a tanker full of heating oil. However, if the tanker is diverted elsewhere prior to delivery, and the hedge is not immediately liquidated, the hedge may be deemed speculative for reasons beyond the control of the Energy Provider.

In addition, the link between hedging and speculative transactions that stems from the "crowding out" provisions appears to present problems for economically effective, but imperfect hedges that are routinely transacted in energy markets. Specifically, due to the unique character of energy markets, an Energy Provider may have a commercial risk that it cannot hedge directly and, therefore, will enter into an imperfect hedge that is believed to perform similarly to the risk that it wishes to mitigate. Because these hedges are substitute for transactions to be made or positions to be taken at a later time in a physical market, and are "economically appropriate to the reduction of risks," they fall within the general definition of a "bona fide hedge transactions or positions" set forth in Rule 1.3(z)(1) of the Commission's regulations.[22] If these transactions do not qualify for the *bona fide* hedge exemption proposed in the NOPR, they must be treated as speculative transactions. Such treatment would eliminate the ability of market participants, particularly Energy Providers, to execute the most effective hedge available to mitigate their underlying commercial risk in physical energy markets.

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[21] *See* Federal Energy Regulatory Commission, *State of the Markets Report 2009*, at 2-10 (April 15, 2010).

[22] 17 C.F.R. § 1.3(z)(1).

c. The Proposed "Crowding Out" Provisions Heighten the Risk of Flight from U.S. Markets in the Referenced Energy Contracts.

Market participants' efforts to minimize their exposure to the regulatory risk associated with the proposed "crowding out" provisions could trigger a flight from U.S. futures markets and markets for SPDCs on ECMS in which Referenced Energy Contracts are transacted. These provisions may create incentives for market participants (i) to trade in foreign markets to avoid triggering loss of their speculative capability or (ii) to leave the futures markets entirely. Such activity would have a significant, adverse impact on liquidity in the markets for the Referenced Energy Contracts.[23] Moreover, the "crowding out" provisions would not only undermine transparency in futures markets, but could also expose consumers in the U.S. to increased price volatility associated with the underlying physical commodities and likely result in higher prices for such commodities.

d. Entities Engaged in *Bona Fide* Hedging Should Not Be Constrained in their Ability to Speculate in Energy Markets.

Speculation is critical to the efficient operation of well-functioning markets for the Referenced Energy Contracts. Commercial Energy Providers that enter into speculative transactions help provide liquidity to these markets. However, the proposed "crowding out" provisions eliminate the ability of Energy Providers relying on *bona fide* hedge exemptions to engage in speculation. Moreover, these provisions affect **all** trading activity in markets for the Referenced Energy Contracts. They are not limited in application exclusively to trading activity that constitutes "excessive speculation."

For example, the artificial and unjustified link between the amount of hedging and speculative activity engaged in by a market participant establishes a framework where: (1) each new hedge position put on by an Energy Provider effectively limits its capacity to speculate (even if the Energy Provider is not close to the applicable federal speculative position limit for a Referenced Energy Contract); and (2) each speculative trade by an Energy Provider effectively reduces its remaining capacity to hedge (in the same market). The Working Group is concerned that the limitations imposed by this framework will significantly reduce liquidity in markets for

[23] Energy markets will be harmed if swap dealers, for example, are forced out of the speculative market because the "crowding out" provisions have limited them to hedging transactions. Also, certain end-users may be harmed as swap dealers "close" their client window to avoid losses associated with unwinding their speculative positions. Even if dealers were to only run hedge books, the market would be harmed by the loss of speculation by dealers, who bring both liquidity and sophistication to the market as a whole.

the Referenced Energy Contracts which will, in turn, harm Energy Providers and consumers alike.[24]

Trading on a speculative basis is important to Energy Providers for reasons other than proprietary ones. For example, price discovery data generated by speculative transactions provides Energy Providers with the insights necessary for establishing the most effective and precise hedge possible to ensure that they (i) are adequately protected from price volatility and (ii) can meet their underlying physical delivery obligations to customers as efficiently as possible in the dynamic and highly competitive energy business. Moreover, speculative activity provides trading insights to assure that Energy Providers receive competitive and fair price quotations from other market participants in markets for the Referenced Energy Contracts.

The Working Group is also concerned that the proposed "crowding out" provisions inherently and unfairly favor certain market participants and disadvantage others. As noted above, Energy Providers and other commercial market participants that enter into hedges lose their capacity to speculate as their respective hedge volumes increase. However, other market participants are relatively unaffected by these provisions, notably large traders that do not engage in hedging transactions. By limiting the ability of commercial firms engaged in hedging activities to speculate, the "crowding out" provisions effectively reserve the speculative market in the Referenced Energy Contracts for large speculators.[25]

Given the vital importance of energy commodities to our national economy, the Working Group respectfully submits that the Commission should reconsider the "crowding out" provisions as discussed herein and remove them from any final rule issued in this proceeding. Doing so will avoid a situation in which burdensome and unnecessary costs are imposed on hedging activities involving the Referenced Energy Contracts, without any corresponding benefit to market integrity and protection.

2. **The Commission Has Not Adequately Demonstrated that the Federal Speculative Position Limits Are Needed to Protect Against Excessive Speculation.**

The Working Group supports the views of other interested parties in this proceeding that the Commission did not provide a sufficient basis in the NOPR to support federal speculative

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[24] Energy Providers, as an incidental part of their primary business, periodically enter into OTC hedge transactions with customers that are designed to mitigate the customers' price risk associated with the underlying physical transactions between the parties. The "crowding out" provisions set forth in Section 151.3(a)(1)(ii) could effectively preclude Energy Providers from entering into such offsetting transactions, as these transaction might not qualify as a *bona fide* hedges.

[25] In this regard, the "crowding out" provisions appear to create a separate and discriminatory test for "excessive speculation" for traders that hold positions covered by *bona fide* hedge exemptions.

position limits as necessary to protect against excessive speculation in the Referenced Energy Contracts.[26]

The NOPR cites Section 4a(a) of the CEA as the relevant, statutory authority for imposing federal speculative position limits.[27] Although volatility is inherent in physical energy markets, the NOPR does not provide any quantifiable evidence that financial transactions in futures markets are the *de facto* cause of increased volatility in the physical markets underlying the Referenced Energy Contracts.[28] Rather, it states in summary fashion that the proposed federal speculative position limits are necessary to prevent "potential harms" that could arise from concentrations of large speculative positions in the Referenced Energy Contracts.[29] The failure to provide a quantifiable, factual basis for imposing such limits for the Referenced Energy Contracts raises concerns that the Commission has not complied with the requirements of the Administrative Procedures Act to engage in reasoned decision making.[30]

The federal speculative position limits proposed in the NOPR, *by design*, limit concentrations of large positions in the Referenced Energy Contracts. Section 4a(a), however, is clear that the Commission may only implement federal speculative position limits to prevent excessive speculation, not position concentrations. Despite the Commission's concerns that unreasonable and abrupt price movements may result from the liquidation of large concentrated positions, the NOPR lacks any empirical, quantifiable evidence that large position concentrations harm liquidity or the pricing of energy commodities.[31]

In addition to its failure to satisfy the legal burden set forth in Section 4a(a) of the CEA, the NOPR provides no substantive cost-benefit analysis (i) establishing the need for the federal speculative position limits for the Referenced Energy Contracts, or (ii) discussing the effects that such limits may have on the markets for the Referenced Energy Contracts. For example, the NOPR is devoid of any substantive analysis addressing the effects to markets if large traders were to limit their trading activity in the Referenced Energy Contracts to comply with the proposed federal speculative position limits. It is the Working Group's view that that markets likely would be harmed if traders reduced their activities. Before imposing a new framework on energy markets that are recognized for their efficiency and transparency, the Commission

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[26] *See FIA Comments* at 17-20.

[27] NOPR at 4145, 4148-4149. Under CEA Section 4a(a), the Commission may impose position limits if trading activity in the derivatives market causes price volatility in the related physical markets for the reference commodity.

[28] Such price volatility also has not been seen in the futures or ECM markets, a purported hallmark of speculative activity.

[29] NOPR at 4149.

[30] *See Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (U.S. 1983); *Miller v. Commodities Futures Trading Comm'n*, 197 F.3d 1227 (9th Cir. 1999); *Louisiana PSC v. FERC*, 184 F.3d 892 (D.C. Cir. 1999); *City of Centralia v. FERC*, 213 F.3d 742 (D.C. Cir. 2000).

[31] NOPR at 4149. Moreover, the Commission currently possesses sufficient existing authority under CEA Section 9(a)(2), 7 U.S.C. § 13(a)(2), to prevent inappropriate position concentrations.

should undertake a thoughtful substantive analysis and evaluate the costs that will likely be imposed by the NOPR. Such analysis is particularly important given that the benefits of imposing the proposed federal speculative limits for Referenced Energy Contracts are also not well established in the NOPR.

3. The Aggregation Policy Set Forth in Proposed Section 151.4 Should Be Clarified or Amended to Include Necessary Exemptions for Energy Providers.

The aggregation policy set forth in proposed Section 151.4(a) of the CFTC's regulations requires clarification or amendment to include necessary exemptions. In relevant part, Section 151.4(a)(1) will require a party to aggregate "all positions in accounts in which any person, directly or indirectly, has an ownership or equity interest of 10% or greater . . . ." Proposed Section 151.4(a)(2) applies to "[p]ositions held by two or more persons acting pursuant to an express or implied agreement or understanding the same as if the positions were held by, or trading of the positions were done by, a single person."

The Working Group is concerned that the broad language of Section 151.4(a) could be construed to require the aggregation of positions held by a commercial Energy Provider and a corporate affiliate that despite common corporate ownership (i) function as separate and independent traders in markets for Referenced Energy Contracts, (ii) do not, directly or indirectly, hold an ownership or equity interest of 10% or greater in the same position in a Referenced Energy Contract, and (iii) do not transact pursuant to an express or implied agreement or understanding as if their separate positions in a Referenced Energy Contract were held or traded by a single person.

The Working Group respectfully requests that the Commission clarify that the intent of Section 151.4(a) is not to require the aggregation of separate positions held by commercial Energy Providers on their own and for their own purposes simply because they are affiliated through common corporate ownership with another market participant independently transacting in that Referenced Energy Contract. Further, as discussed in Section III.A.3.b, the Working Group suggests that the Commission amend the proposed text of Section 151.4(a) to provide greater certainty regarding the appropriate scope and applicability of this provision.

As explained below, absent such clarification or amendment, Section 151.4(a) will have a significant and chilling impact on future investment in the energy sector. In addition, it could

have the unintended consequence of resulting in the violation of other federal and state energy regulatory requirements applicable to certain Energy Providers.[32]

a. Chilling Effect on Future Investment in the Energy Sector.

As proposed, the broad language of Section 151.4(a) might require the aggregation of positions across affiliates transacting in the same market for a Referenced Energy Contract based solely on common corporate ownership. Such a requirement will act as a disincentive to future investment in the energy sector. The aggregation of positions should not be broadly applied across affiliates on the basis that these entities share a common corporate owner unless the common owner manages, directs, or otherwise controls its subsidiaries' day-to-day trading decisions and related business operations.

It is generally recognized that, other than possessing certain limited consent rights necessary to protect their economic investment interests, passive owners do not manage, direct, or otherwise control the day-to-day business operations of an Energy Provider. Due to the corporate separation embedded in these ownership structures, passive owners are unable to influence the day-to-day trading activities and decisions of an Energy Provider and its affiliates, including the hedging of price risk associated with its underlying physical commodity portfolio and price discovery activities.

In a final rule adopted in May 1999, the Commission adopted exemptions to its existing aggregation rules set forth in Section 150.4 of its regulations and noted that the "hold or control" criteria in CEA Section 4a would be interpreted as applying separately to ownership of positions or to the control of trading decisions.[33] The *Speculative Limit Final Rule* states, in relevant part, that the proposed exemptions were intended "to respond to the continuing trend toward mergers and consolidation in the financial services sector."[34] The Commission then exercised discretion in determining the level or type of ownership that would trigger the Section 4a ownership test.[35]

The aggregation requirements in Section 151.4(a) should be applied in a manner that is generally consistent with "hold or control" guidance set forth in the *Speculative Limit Final*

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[32] *Market-Based Rates for Wholesale Sales of Electric Energy, Capacity and Ancillary Services by Public Utilities*, Order No. 697, FERC Stats. & Regs. ¶ 31,252, *clarified*, 121 FERC ¶ 61,260 (2007), *order on reh'g*, Order No. 697-A, FERC Stats. & Regs. ¶ 31,268 (2008), *clarified*, 124 FERC ¶ 61,055 (2008) *order on reh'g*, Order No. 697-B, FERC Stats. & Regs. ¶ 31,285 (2008), *order on reh'g*, Order No. 697-C, 127 FERC ¶ 61,284 (2009), *clarified*, 131 FERC ¶ 61,021 (2009)("Affiliate Restriction Regulations"). *See e.g.,* Or. Admin. R. 860-038-0600 (2010)(prohibiting the joint marketing, advertising or promotional activities between regulated and competitive energy affiliates); Or. Admin. R. 860-038-0620 (2010)(requiring the maintenance of separate books and records by regulated and competitive energy affiliates).

[33] *See* 17 C.F.R. § 150.4; *Revision of Federal Speculative Position Limits and Associated Rules*, Final Rule, 64 Fed. Reg. 24,038 at 24,043 (May 5, 1999)("*Speculative Limit Final Rule*")

[34] *Id.*

[35] *Id.* at 24,043-24,044.

Rule. In addition to being consistent with the Commission's existing interpretation of Section 150.4, this approach is consistent with the body of well-developed precedent and guidance established by the Federal Energy Regulatory Commission ("FERC") and the Securities and Exchange Commission ("SEC") recognizing the fundamental corporate separation embedded in passive ownership structures and the inability of passive owners to manage, direct, or otherwise control the day-to-day business operations of an Energy Provider.

For example, FERC has developed a body of precedent addressing whether the acquisition of a passive ownership interest in a "public utility" constitutes a "change in control" requiring prior approval under Section 203 of the Federal Power Act ("FPA").[36] Importantly, this body of FERC precedent recognizes, in relevant part, that passive ownership structures granting investors certain limited rights over fundamental business decisions necessary to protect their investments, *e.g.,* veto or consent rights, do not convey (i) day-to-day operational control or (ii) control over activities that are subject to its jurisdiction under the FPA (*e.g.,* engaging in wholesale sales).[37]

FERC's *Supplemental Policy Statement* issued in 2007 also reflects this well-established view.[38] The *Supplemental Policy Statement* uses certain criterion to determine whether the acquisition of passive ownership interests triggers a "change in control" requiring prior approval under FPA Section 203. As set forth below, this criterion specifically focuses on the ability of the proposed passive owner to influence the day-to-day jurisdictional activities of a public utility:

- acquired interest does not give the acquiring entity authority to manage, direct or control the day-to-day jurisdictional activities;
- acquired interest gives the acquiring entity only limited rights (*e.g.,* veto and/or consent rights necessary to protect its economic investment interests, where those rights will not affect the ability of the jurisdictional public utility to conduct jurisdictional activities); and

[36] 16 U.S.C. § 824b; *AES Creative Res., L.P. et al*, 129 FERC ¶ 61,239 at P 28 (2010)("*AES*"); *FPL Energy Mower County, et al.*, 121 FERC ¶ 61,252 (2007); *ITC Holdings Corp., et al.*, 102 FERC ¶ 61,182 at 42 (2010); *D.E. Shaw Plasma Power, LLC*, 102 FERC ¶ 61,265 at P 19, (2003); *Colstrip Energy Limited Partnership,* 82 FERC ¶ 62,195 (1997),); *see also Alliance Cos.,* 91 FERC ¶ 61,152, at PP 26-27 (2000), *order on reh'g*, 94 FERC ¶ 61,070 (2001); *Arizona Public Service Co.,* 101 FERC ¶ 61,033, at PP 39, 49 (2002) (reserving limited veto rights with respect to enumerated business decisions by the Board); *GridSouth Transco,* 94 FERC ¶ 61,273 (2001) (giving passive owners veto rights over fundamental business decisions of proposed regional transmission organization); *GridFlorida*, 94 FERC ¶ 61,363 at P 61 (2001)(same).

[37] *AES* at PP 25-28. *See also, FPA Section 203 Supplemental Policy Statement*, 120 FERC ¶ 61,060, at P 54 (2007) ("*Supplemental Policy Statement*") ("[i]nvestments in public utilities that do not convey control may in some cases be considered to be passive investments not subject to section 203(a)(1)(A) (unless there is a sale or lease of the facilities)"). *Id.*

[38] *See Supplemental Policy Statement* at P 54.

- acquiring entity has a principal business other than engaging in producing, selling, or transmitting electric power.[39]

The SEC advanced a similar policy position in no action letter guidance ("SEC Guidance") addressing whether passive investors in public utility where subject to regulation as a "holding company" under the Public Utility Holding Company Act of 1935 ("1935 Act").[40] The SEC Guidance also recognizes the separation imposed by passive ownership structures between investors and personnel responsible for the day-to-day operation and control of a pubic utility. As a consequence, the SEC has consistently taken the position that entities acquiring certain passive ownership interests, including those with certain limited consent rights, were not subject to regulation under the 1935 Act as "holding companies" because the owners could not control the day-to-day business activities of an Energy Provider.[41]

Based on the foregoing, the Working Group respectfully submits that, to the extent the trading activities of an Energy Provider and its affiliates transacting in the same Referenced

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[39] *Id.*

[40] In August 2005, Congress enacted the Energy Policy Act of 2005 ("EPAct"). *See* 2005, Pub. L. No. 109-58, § 1289, 119 Stat. 594. Among other things, EPAct repealed the 1935 Act that and replaced it with Public Utility Holding Company Act of 2005 ("PUHCA 2005"), 16 U.S.C.§ 825. PUHCA 2005 focuses "on increased access to holding company books and records to assist [the Commission] and state utility regulators in protecting customers of regulated utilities." Specifically, PUHCA 2005 complements the Commission's existing authority under the FPA and Natural Gas Act by giving the Commission access to holding companies' books and records. PUHCA 2005 also grants the Commission power to review and authorize the allocation of costs for non-power goods and services at the request of a holding company system or state commission.

In February 2006, FERC implemented PUHCA 2005 through the issuance of Order No. 667 and its progeny, and new regulations codified at 18 C.F.R. Part 366 *et seq. Repeal of the Public Utility Holding Company Act of 1935 and Enactment of the Public Utility Holding Company Act of 2005*, Order No. 667, FERC Stats. & Regs. ¶ 31,197 (2005), *order on reh'g*, Order No. 667-A, FERC Stats. & Regs. ¶ 31,213 (2006), *order on reh'g*, Order No. 667-B, FERC Stats. & Regs. ¶ 31,224, *order on reh'g*, Order No. 667-C, 118 FERC ¶ 61,133 (2007) ("Order No. 667"). To date, the Commission has not established a substantial body of precedent addressing the circumstances pursuant to which it would deem passive ownership interests with consent rights in a public utility and/or electric utility company to be "voting securities" under PUHCA 2005. Given this situation, FERC noted in Order No. 667 that it would initially look to prior, relevant SEC precedent and past practice under the 1935 Act when interpreting PUCHA 2005.

[41] The primary consideration for issuing the above-referenced SEC Guidance was whether, based on the totality of facts and circumstances presented, passive ownership interests with consent rights provided the entities holding such interests (*i.e.,* investors) limited rights to protect their economic investment in an Energy Provider. If the consent rights effectively provide investors with the ability to assert a controlling influence over the day-to-day operations of the public utility, then these ownership interests would not be deemed passive, and would be treated as "voting securities" under the 1935 Act. Consequently, investors holding such interests would be subject to regulation as "holding companies." *See Neptune, LLC*, 2005 WL 2000748 (2005); *Evercore NETC Investments Inc*., 2003 WL 23095243 (2003); *k1 Ventures, et al*., 2003 WL 21751451 (2003); *General Electric Capital Corp*., 2002 WL 837537 (2002); *SW Acquisition L.P.*, 2000 WL 430610 (2000); *Berkshire Hathaway* Inc., 2000 WL 294900 (2000); *Torchmark Corporation*, 1996 WL 303056 (1996); *Nevada Sun-Peak Limited Partnership*, 1991 WL 178782 (1991); *Colstrip Energy Limited Partnership*, 1988 WL 234462 (1998); but see, *Kaufman and Broad Inc.,* 1985 WL 55508 (1985) & *Noverco, Inc.,* 1987 WL 107878 (1987)(SEC declined to issue no action letters because the proposed passive ownership structure provided too much control over the voting securities).

Energy Contract are not undertaken at the direction, management or control of a common corporate owner, they should be treated as separate and independent traders for purposes of determining compliance with applicable federal speculative position limits, unless they jointly (i) hold or control an ownership or equity interest of 10% or greater in the ***same*** position in a Referenced Energy Contract and (ii) transact pursuant to an express or implied agreement or understanding as if their separate positions in a Referenced Energy Contract were held by, or the trading of such positions were done by, a single person.

b. Violation of Federal or State Law Applicable to Certain Energy Providers.

Further, an overly broad interpretation of the proposed aggregation policy set forth in proposed Section 151.4(a) could have the unintended consequence of resulting in violations of certain federal and state laws applicable to Energy Providers.[42] For example, certain regulatory requirements imposed by FERC that apply to traditionally regulated public utilities and their affiliated energy marketers would make the aggregation of positions across affiliates unworkable.

Specifically, interactions between a traditional, franchised public utility with captive customers and its "market-regulated power sales affiliates" (*i.e.,* affiliated energy marketers) that are authorized to transact wholesale sales of electric energy at market-based rates pursuant to FPA Section 205 are subject to the Affiliate Restriction Regulations imposed by FERC.[43] In relevant part, the Affiliate Restriction Regulations require the functional separation and independent operation of such entities, and are intended to prevent potential affiliate abuse, including cross-subsidization issues, that could benefit shareholders to the detriment of captive ratepayers.[44]

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[42] *See* note 33 *supra*.

[43] 16 U.S.C. § 824d; 18 C.F.R. § 35.39.

[44] Specifically, the FERC Affiliate Restriction Regulations require public utilities and their "market regulated power sales affiliates" to *physically, operationally, and functionally separate to the maximum extent practicable* personnel engaged in activities relating to the execution of generation functions or the purchase and sale of electricity at wholesale on their behalf (collectively, "Marketing Functions"). 18 C.F.R. § 35.39(c). Traditional utilities and their "market-regulated power sales affiliates" are also prohibited from sharing any senior officers and other supervisory personnel that engage in directing, organizing or executing generation or marketing functions. *Id.* § 35.39(c)(2)(ii). Under FERC's Affiliate Restriction Regulations, a traditional utility may not share any non-public "market information" with employees of market-regulated power sales affiliates engaged in Marketing Functions if that information can be used to the detriment of captive customers, unless such information is simultaneously disclosed to the public. *Id.* § 35.39(d)(1). In addition to the foregoing, the Affiliate Restriction Regulations require that that non-power goods and services provided by a traditional utility to a market-regulated power sales affiliate be priced at the higher of the traditional utility's cost or market. *Id.* § 35.39(e). Similarly, market-regulated power sales affiliates are prohibited from selling non-power goods and services to a traditional utility affiliate at above-market prices. *Id.* Further, the brokering of any purchases or sales of electric energy at wholesale by a market-regulated power sales affiliate on behalf of traditional utility affiliate are subject to certain limitations. *Id.* § 35.39(f)(1).

To the extent that a traditional utility and its "market-regulated power sales affiliate" transacting in markets for a Referenced Energy Contract are forced to share position information to ensure "global" corporate compliance with aggregate position limits for that contract, each would effectively violate FERC's Affiliate Restriction Regulations, notably the independent operation requirement and the prohibition on the sharing of market information.[45] The failure to comply with FERC's Affiliate Restriction Regulations, even an inadvertent failure, could expose these entities to civil penalties of up to $1 million per violation per day and could result in the suspension or revocation of their respective authorizations to engage in wholesale sales of electric energy at market-based rates under FPA Section 205.[46]

The Working Group respectfully requests that the Commission clarify that the aggregation policy of proposed Section 151.4(a) would not apply to Energy Providers if compliance with these requirements would result in a violation of applicable federal or state law, such as FERC's Affiliate Restriction Regulations. In the alternative and to provide greater regulatory certainty, the Working Group suggests that the Commission amend the language of Section 151.4(a) to include a necessary exemption for parties whose efforts to comply with this provision would result in the violation of other applicable federal or state laws.

4. **The Commission Should Carefully Define "Deliverable Supply" For Position Limits Applicable to Contracts in the Spot Month.**

As proposed in the NOPR, position limits for the spot month are based upon deliverable supply. The construct of "deliverable supply" as a reference amount is consistent with the statutory foundation for position limits under CEA Section 4a, because the construct limits the disruption of physical markets by trading activity in the futures markets. However, this construct faces difficulties in application that must be resolved before a rule implementing speculative position limits is formally adopted by the Commission.

The central issue is determining what the "deliverable supply" is for each of the Referenced Energy Contracts. The reference amount is, at best highly subjective and, at worst, unknowable until after the applicable period has passed. Moreover, there are a number of variables that affect the deliverable supply, especially for the Referenced Energy Contracts, including, but not limited to (i) amounts in held in storage, (ii) remaining storage capacity, (iii) refining capacity, (iv) shipping capacity, (v) geo-political events, (vi) demands for the Referenced Energy Contracts in foreign markets and (vii) regulatory impacts (*e.g.*, labor, environmental, commerce, etc.).

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[45] *See Florida Power Corp, et al.*, 111 FERC ¶ 61,243 (2005)(requiring the refund of approximately $6.5 million to ratepayers, in relevant part, for identified violations of the independent functioning rules and prohibition on sharing market information as set forth in FERC's Code of Conduct requirements (precursor to the Affiliate Restriction Regulations) applicable to franchised public utilities and marketing affiliates authorized to engage in wholesale sales of electric energy at market-based rates).

[46] 16 U.S.C. § 825o-1 (setting forth FERC's civil penalty authority under Part II of the FPA); *see also Policy Statement on Civil Penalty Guidelines*, 130 FERC ¶ 61,220 (2010).

The Working Group respectfully submits that, on the whole, these variables make it difficult to determine what specifically constitutes "deliverable supply." Variables may also result in a fundamental disconnect between the type of market regulation and transparency sought to be imposed through the NOPR and the actual demands of the market. Taken together, these will affect the way market participants conduct their activities in a manner that will disrupt energy markets. Accordingly, the deliverable supply methodology ultimately adopted by the Commission must be (i) clear and transparent to all market participants, (ii) flexible enough to adapt to the continuing evolution and growth of markets for the Referenced Energy Contracts, and (iii) subject to periodic review at regularly scheduled intervals to ensure that the methodology is updated as necessary.

5. Definition of "Swap Dealer."

The NOPR proposes to adopt new Section 151.1 of the Commission's regulations, which defines the term "swap dealer," specific to commodities markets and regulation by the CFTC under the CEA.[47] Specifically, this definition states that a "swap dealer" is:

> "[A]ny person who, as a significant part of its business, holds itself out as a dealer in swaps, engages in the purchase of swaps and their resale to customers in the ordinary course of business, or engages in any activity causing the person to be commonly known in the trade as dealer or market maker of swaps."

As currently drafted, the proposed definition of "swap dealer" is overly broad. However, this definition can be properly tailored with some modification. Specifically, the definition of "swap dealer" must encompass all market participants commonly understood to be dealers, but it should not be so expansive that it inadvertently captures commercial Energy Providers. Energy Providers derive the bulk of their profits not from entering into futures or derivatives transactions with customers or trading futures or derivatives for proprietary purposes, but from producing, marketing, or delivering physical energy commodities to consumers.

A workable definition of "swap dealer" must recognize that the activities of traders and dealers at times overlap. That is, a trader will engage in some of the activities performed by a dealer, but not all activities performed by a dealer. The Securities and Exchange Commission ("SEC") recognizes and addresses this overlap in the guidance interpreting the definition of "dealer" under Section 3(a)(5) of the Securities Exchange Act of 1934, as amended.[48]

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[47] NOPR at 4160.

[48] *See Definition of Terms in Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934*, Final Rule, SEC Release No. 34-47364 (Mar. 2003); *Definition of Terms in Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934*, Proposed Rule, SEC Release No. 34-46745 (Dec. 2002). This SEC guidance is referred to as the "Dealer/Trader Distinction."

The Working Group respectfully submits that an appropriately tailored definition of "swap dealer" set forth in proposed Section 151.1 should also expressly recognize the similarities and differences between traders and dealers.[49] The SEC's Dealer/Trader Distinction guidance is helpful in this regard. Specifically, it recognizes that such a definition must be crafted in a manner that looks at the sum of a market participant's activities, not any one particular activity, before determining whether that market participant is, in fact, a "swap dealer." A workable definition of "swap dealer" requires the consideration of a market participant's trading activities in the overall context of its business, since a swap dealer's primary business concern is its trading-related activities.

As shown below, the Working Group suggests that the definition of "swap dealer" in proposed Section 151.1 of the Commission's regulations can be made sufficient by changing one qualifier and restyling the definition in a conjunctive manner:

> Swap dealer means, solely for the purposes of this part and §1.45 and part 20 of this chapter, any person who, as a ~~significant~~ primary part of its business, holds itself out as a dealer in swaps, makes a market in swaps, regularly engages in the purchase of swaps and their resale to customers ~~in the ordinary course of business, or~~ and engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps; *provided*, that a "swap dealer" shall not include any person that has as its primary business the ownership, use, production, processessing, manufacture, distribution, merchandizing or marketing of a physical commodity either individually or in a fiduciary capacity and whose outstanding open swap positions are primarily associated with that business activity.

Among the enumerated criteria set forth in this definition, should also be (i) advertising and the willingness to buy or sell swaps on a continuous basis and (ii) advertising and providing ancillary trading services, such as rendering investment advice or extending or arranging for credit.

Energy Providers, both big and small, transact in futures and OTC markets. At times, that trading activity may resemble the activity of a swap dealer. However, these overlapping activities do not make Energy Providers "swap dealers." An overly broad definition of "swap dealer" may result in the unintended consequence of an Energy Provider's entire commercial enterprise being regulated as a "swap dealer". Further, if the proposed position aggregation rules discussed in Section III.A.3 are interpreted in an overly broad manner, all affiliates within

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[49] The CFTC already recognizes this distinction to a limited extent in another context. Specifically, in CFTC Form-40, Statement of Reporting Trader, Schedule 1 provides two distinct categories of market participants for natural resource futures and options: "Swaps/Derivatives Dealer" (without explanation) and "Dealer/Merchant" (*e.g.*, wholesaler, exporter/importer, shipper, grain elevator operator, crude oil marketer).

the same corporate family, including, for example, a utility affiliate that trades strictly to hedge fuel costs, would be subject to the full range of limitations applicable to "swap dealers," notably the rigid and overly restrictive "crowding out" provisions applicable to the proposed *bona fide* hedge exemptions for Referenced Energy Contracts. The Working Group respectfully submits that such costs are unnecessary, particularly relative to the lack of perceived benefits.

B. RESPONSES TO SPECIFIC REQUESTS FOR COMMENTS.

The Working Group would like to respond to certain questions set forth in the NOPR. The number of the question is as it appears in the NOPR.

1. Federal Speculative Position Limits Do Not Solve an Observed Manipulation of Physical Energy Markets

Question No.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?

Response: No. The burdens on interstate commerce are merely theoretical. However, the costs associated with position limits are real, tangible, and immediate.

As discussed above, the Working Group is unaware of any definitive research identified in the record that trading activity in financial markets involving the Referenced Energy Contracts have caused price volatility in the underlying physical commodity markets. The Commission's report on alleged manipulation of oil markets published in July 2008 specifically found that price changes in the physical markets were driven by fundamental market forces in the physical markets and not by influence in the derivatives markets.

The style of this question presupposes a tenuous statutory interpretation that underpins the NOPR. That is, the Commission argues that it need only identify a potential abuse before imposing regulation. In part, this supports the common sense understanding that regulators are charged with protecting markets by proactively addressing potential problems. However, to be a meaningful power, the problem to be solved must have indicia of immediacy beyond being a theoretical possibility. A number of potential harms are theoretical, but many are not real. Without further evidence of an imminent threat, such regulation, at best, is arbitrary and, at worst, is harmful to the effective operation of efficient markets. The Commission would need to provide a reasoned basis as to why it specifically addressed one, but not all, of the theoretical threats. Also, if the Commission were to issue a raft of regulations to address the multitude of theoretical threats, then such action would cause an unnecessary chill to the efficient operation of the markets.

The NOPR offers no evidence that excessive speculation in markets for the Referenced Energy Contracts has burdened interstate commerce. More importantly, should these burdens actually exist, the NOPR does not offer any empirical and quantifiable evidence that federal speculative position limits would have any impact in mitigating such burdens. To the contrary, the imposition of federal speculative position limits may result in their own unintended, harmful impact on the integrity of the markets.

The Working Group is not aware of any substantive analysis conducted by the CFTC to assess what, if any, negative affects the proposed federal speculative position limits would have on the integrity and proper functioning of the markets, and whether the potential benefits of the

proposed limits outweigh the potential burdens. As discussed in Section III.B.2, it is the Working Group's view that deep, liquid markets for the Referenced Energy Contracts with broad participation (i) provide the most meaningful price discovery for Energy Providers and (ii) are the least susceptible to volatility and manipulation.

2. **Alternatives Measures That May Be Utilized to Prevent Excessive Speculation and Manipulation of Energy Markets.**

Question No. 2: Are there methods other than Federal speculative position limits that should be utilized to diminish, eliminate, or prevent such burdens?

Response: The case supporting the imposition of federal speculative position limits for the Referenced Energy Contracts has not been adequately made in the NOPR. The question set forth above assumes that a burden exists on the physical markets or can exist as a result of position concentration in the markets for the Referenced Energy Contracts. However, as noted in Section III.A.2, position concentration concerns in futures markets and markets for SPDCs traded on ECMs are not the proper subject of CEA Section 4a. Moreover, the existence of a burden resulting from excess speculation has not been established in the NOPR or in other materials made public by the Commission. In the absence of a demonstrated burden on interstate commerce resulting from excessive speculation, the Working Group respectfully submits that no method or other remedy, including the proposed federal speculative position limits, need be imposed on markets for the Referenced Energy Contracts at this time.

Conversely, market manipulation in futures markets is a real, identifiable risk. As discussed in Section III.A., the Commission possess sufficient (i) existing authority under the CEA and (ii) capability through its market surveillance and enforcement programs, to effectively police this risk and protect the markets for the Referenced Energy Contracts against the threat of manipulation. It is notable however, that the proposed position and concentration limits may very well *increase* the risk of market manipulation by decreasing liquidity. Deep, liquid markets with broad participation are the most effective protection against the threat of manipulation. It is counterintuitive that the Commission that may very well heighten the threat of the real and identifiable risk of market manipulation, the prevention of which is a centerpiece of its statutory mission, in order to address an unidentified "burden" that has not been shown to exist and for which there is no way to determine whether or not the proposed measures would be effective.

3. **Methodologies for Determining Whether to Establish Federal Speculative Position Limits in Energy Markets.**

Question No. 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: As an initial step, the Commission should identify and quantify an actual imbalance in the physical commodity markets that results from a market concentration in a Referenced Energy Contract. Then, by establishing this control set, the Commission can measure the effect of its regulation.

This question also raises another related and equally important question. Specifically, what are the methods and assumptions the Commission has used to determine the actual economic impact associated with the imposition of federal speculative limits for the Referenced Energy Contracts? Other than a statement that the Commission's analysis indicates the position limits will impact only a few traders, there has been no empirical evidence upon which the Commission has evaluated the broader impact of position limits. For example, how has the Commission modeled the effect to the overall market if a few large trading positions withdraw from the market once the traders holding such positions approach the position limit?

Any analysis by the Commission regarding the effects of federal position limits must account for the use of positions in the Referenced Energy Contracts as proximate hedges of other, but not direct, exposures, *i.e.,* economically effective, but imperfect hedges. For example, firms might use Henry Hub natural gas futures to hedge exposures related to wind generation or natural gas at another location. The Commission, in this process, will need to establish guidelines for determining when a position qualifies as a hedge for indirect exposures.

Further, such an analysis should consider whether there are alternatives other than hard position and concentration limits that may be less disruptive to markets, but equally effective. For example, the NOPR contains no evidence that the Commission has assessed the value and effectiveness of accountability rules. Accountability levels may prove to be equally as effective in addressing the Commission's concerns, while also preserving market liquidity and participant flexibility.

4. Treatment of Contracts That Settle to the Average Price of a Sub-Group of Contracts Within a Class During the Spot Month.

Questions No. 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: The Working Group requests that the Commission restate this question with an example. There is some uncertainty as to how the Commission defines the sub-group of contracts as being within the same class. For example, are each of the referenced contracts "within a class" because they reference yet another lower-tier contract?

5. Customary Position Sizes Held by Speculative Traders.

Question No. 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…"

Response: The Working Group requests that the Commission restate this question. It is not clear what "moderating the limit levels" is intended to mean. The language could be interpreted as "further reducing established position limits" or, as "relaxing the established limits thereby allowing larger established position limits."

However, in either case, customary position sizes held by speculative traders should not be a factor in "moderating limit levels" because the definition of "customary" is a moving target. Specifically, "customary" speculative positions are dependent on a number of dynamic variables, including the health of credit markets, prevailing interest rates, current and potential energy market volatility, and real and perceived imbalances in energy market fundamentals. To apply a relatively static limit based on such dynamic variables is, at best, impractical, and at worst, detrimental to the liquidity and smooth functioning of the price discovery mechanism of the energy markets. Furthermore, if "customary" means "average," the position limits would trend lower without a corresponding benefit of preventing abusive market power.

6. Adoption of Formal Guidelines for the Implementation of Position Accountability Rules.

Question No. 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 Working Group does not feel that it is necessary for the Commission to issue acceptable practices that adopt formal guidelines and procedures for implementing position accountability rules. However, the Working Group believes it would be helpful for the Commission to study the effectiveness of current position accountability rules, and assess whether they would be an equally effective alternative for addressing the same burdens that the proposed federal speculative position limits are purportedly designed to address.

The NOPR does not present any evidence that existing accountability rules are ineffective. The Working Group submits that the use of accountability levels is an equally effective measure for addressing the Commission's concerns, while at the same time (i) preserving market liquidity and (ii) being less burdensome on market participants. However, the NOPR does not provide any substantive analysis on this issue.

7. Alternatives to Swap Dealer Risk Management Exemption.

Question No. 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?

Response: Federal legislation likely will provide the Commission with sufficient transparency into the OTC market, thus allowing it to verify the "look through" of a swap dealer's hedge. Given the liquidity and valuable customized hedging services provided by dealers, the Working Group would prefer dealers not be subject to a "cap" on applicable exemptions.

8. Impacts of Pending Derivatives Reform Legislation on the Implementation of Federal Speculative Position Limits.

Question No. 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: As discussed in Section III.A., the Commission should stay the instant proceeding pending the outcome of legislative developments in Congress regarding proposals to reform the regulation of OTC derivatives markets. The Working Group is concerned that both the Commission and participants in energy markets will expend considerable effort in developing and possibly implementing federal speculative position limits, only to be required to reconstruct their compliance programs to ensure that such limits are consistent with the regulatory framework adopted as part OTC derivatives reform legislation enacted by Congress. The benefits of waiting to release a final rule implementing federal speculative position limits for the Referenced Energy Contracts that is consistent with newly enacted legislation outweigh the potential costs associated with implementing new requirements now and, shortly thereafter, having to modify - possibly materially - such limits.

The imposition of position limits in the OTC derivatives markets is likely to be highly disruptive. If Congress ultimately does provide the Commission with expanded authority under the CEA to set position limits in OTC derivative instruments, it is imperative that the Commission regulate the OTC market with a high degree of restraint and precision. The failure to implement thoughtfully developed limits for derivatives traded in OTC derivatives markets will likely constrict liquidity in energy markets, thus increasing market volatility and, ultimately, prices for the physical energy commodities purchased by consumers.

9. Establishment of Federal Speculative Position Limits for Spot Months and All-Months-Combined.

Question No. 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?

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: With respect to Question No. 14(b), the Commission should not establish all-months-combined position limits on a more frequent basis using a rolling-average of open interest. The Working Group is concerned that the use of a rolling average of open interest for setting federal speculative position limits could result in a situation in which limits for a Referenced Energy Contract are set at an inappropriate level. Specifically, the use of a rolling average assumes that market conditions going forward will be similar to market conditions when the federal speculative position limits were calculated. This approach is fundamentally flawed because market conditions are dynamic, not static. As a consequence, federal speculative position limits established during a period of low trading activity will be slow to respond to changes in market dynamics resulting in increased trading activity and will constrain hedgers and speculators alike. This will impair (i) longer-term liquidity in markets in that contract and (ii) the smooth functioning of price discovery, in the market for the affected Referenced Energy Contract.

10. Implementation of Initial Spot-Month Federal Speculative Position Limits.

Question No. 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?

Response: As discussed in Section III.A.4., there are a number of variables that affect the deliverable supply, especially for the Referenced Energy Contracts, including, but not limited to (i) amounts in held in storage, (ii) remaining storage capacity, (iii) refining capacity, (iv) shipping capacity, (v) geo-political events, (vi) demands for the Referenced Energy Contracts in foreign markets, and (vii) regulatory impacts (*e.g.*, labor, environmental, commerce, etc.).

The Working Group respectfully submits that, on the whole, these variables make it difficult to determine what specifically constitutes "deliverable supply." The affects of these variables may also result in a fundamental disconnect between the type of market regulation and transparency sought to be imposed through the NOPR and the actual demands of the market. Taken together, these will impact the way market participants conduct their activities in a manner that will disrupt energy markets. Accordingly, the deliverable supply methodology ultimately adopted by the Commission must be (i) clear and transparent to all market participants, (ii) flexible enough to adapt to the continuing evolution and growth of markets for the Referenced Energy Contracts, and (iii) subject to periodic review at regularly scheduled intervals to ensure that the methodology is updated as necessary.

IV. CONCLUSION.

The Working Group appreciates this opportunity to comment, and requests that the Commission consider these comments as it develops a final rule in this proceeding. The Working Group expressly reserves the right to supplement these comments as deemed necessary and appropriate.

Respectfully submitted,

*/s/ R. Michael Sweeney, Jr.*___

R. Michael Sweeney, Jr.
David T. McIndoe
Mark W. Menezes

Counsel for the Working Group of Commercial Energy Firms

cc: Honorable Gary Gensler, Chairman
Honorable Scott D. O'Malia, Commissioner
Honorable Jill E. Sommers, Commissioner
Honorable Michael Dunn, Commissioner
Honorable Bart Chilton, Commissioner
Daniel Berkovitz, General Counsel
Stephen Sherrod, Acting Deputy Director, Market Surveillance Section

Sweeney, R. Michael

Name:	R. Michael Sweeney
Full Name:	Sweeney, R. Michael
Organization:	Hunton & Williams LLP;Regulated Industries & Government Relations
Title:	Partner
Telephone Number (Work Voice):	21944
Address (Work):	Washington
Delivery Label (Work):	Washington
Electronic Mail Address (Preferred Internet):	rsweeney@hunton.com

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