**From:** robert.reilley@shell.com
**Sent:** Monday, April 26, 2010 5:07 PM
**To:** secretary <secretary@CFTC.gov>
**Cc:** barbara.browning@SHELL.com
**Subject:** Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations
**Attach:** Shell Trading Comments.pdf

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Dear Mr. Stawick,

Attached, please find Shell Trading's comments in the matter referenced above. Hard copies will be delivered to you and each of the Commissioners tomorrow.

If you have any questions or concerns regarding the attached document, please contact me.

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April 26, 2010

David A. Stawick
Secretary
Commodity Futures Trading Commission
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Washington, DC 20581

Shell Energy North America
Two Houston Center
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Re: Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations

Dear Mr. Stawick:

Shell Trading (US) Company and Shell Energy North America (US), L.P. (together "Shell Trading") are the North American commodity trading arm of Royal Dutch Shell, plc.[1] Shell Trading actively participates in the US energy futures, options and broader derivatives markets, and accordingly has a strong interest in the Commodity Futures Trading Commission's ("Commission") proposed rule on position limits. *Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations*, Notice of Proposed Rulemaking, 75 Fed. Reg. 4143 (Jan. 26, 2010) (hereinafter, "NOPR" or "Proposed Rule").

Shell Trading's role in the energy commodities markets gives it a unique perspective on the issues raised in this rulemaking, and Shell Trading appreciates the opportunity to comment.

## I. Introduction

Shell Trading's business is dependent on the orderly functioning of the physical and financial energy commodities markets. Accordingly, it is important that any new rules relating to US exchanges do not reduce liquidity or transparency; are clear and do not create either unintended incentives or an unwarranted compliance burden. Shell Trading is concerned that the proposed rule could impair the efficient operations of the energy derivatives markets and impose new costs and risks without providing the benefits intended by the Commission.

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[1] Shell Energy North America (US), L.P. ("Shell Energy") and Shell Trading (US) Company (STUSCO) are indirect subsidiaries of Royal Dutch Shell plc. Shell Energy and STUSCO are a part of the Shell Trading global network. Shell Energy markets and trades natural gas, electricity and environmental products, including the natural gas produced by its affiliates. STUSCO trades various grades of crude oil, refinery feedstocks, bio-components and finished oil-related products, and it provides supply and hedging functions (including imports and exports) for affiliated companies. Both Shell Energy and STUSCO transact in the US energy derivatives markets.

Thus, Shell Trading believes that the proposal requires further refinement. Indeed, without further clarification, it is not possible to comment on important aspects of the rule such as its applicability to foreign boards of trade (FBOT), the criteria for hedge exemptions, data collection and the protection of confidential commercially sensitive information. If after receiving comments on the current NOPR, the Commission believes it should establish a new system of position limits, Shell Trading would welcome the opportunity to work with the Commission to develop a revised proposal that meets the Commission's objectives and addresses the concerns and uncertainties described below. Due to its significant energy marketing business, Shell Trading has a material stake in the rules governing markets for energy products. It is willing to offer whatever insight it can to assist the Commission in evolving the proposal to its next stage if the Commission desires to move forward with a rule.

At the highest level, Shell Trading notes that, while the proposed rule is put forth in the context of addressing excessive speculation, its substance solely concerns concentration. If the Commission desires to address "burdens" related to excessive speculation, it should identify those burdens and target rules to address them.

Many of Shell Trading's substantive concerns grow out of the fact that it, like many participants in the energy trading markets, cannot be bucketed as a hedger, speculator or swap dealer. It is a diverse energy commodity merchant that manages risk and optimizes value across dynamic physical and financial, exchange-traded and over the counter markets. As an adjunct to the hedging of its physical exposures, Shell Trading takes speculative positions and it enters into swap transactions related to energy commodities with a variety of counterparties to offset its risks, including credit risks, and to facilitate physical transactions. By failing to recognize the nature and scope of the energy commodity merchant business, the proposed rule may create unintended limitations on legitimate activities.

Because it is responsible for the transportation, storage, delivery and marketing of large volumes of physical energy commodities each day, Shell Trading is concerned about any development that might constrain its ability to manage the risks associated with its physical portfolio. The uncertainty about the application and oversight of the proposed position limits together with the manner in which they interact with each other and the existing position limits is problematic due to the complexity and associated compliance burden of the proposal.

Beyond its ambiguity and complexity, the proposal's "crowding out" provision that would prohibit entities that use hedge exemptions from holding any speculative positions is a significant disincentive to obtain hedge exemptions. It also unnecessarily limits the ability of commodity merchants to undertake the legitimate trading they do today. Shell Trading seriously questions the rationale for such a prohibition, but also has the practical concern that, in many cases, positions held for hedging are indistinguishable from those that might be held speculatively.

The following comments provide additional detail on these and other issues of concern.

Shell Trading is not alone in expressing these concerns. The Comments filed by the Futures Industry Association (FIA), International Swaps and Derivatives Association (ISDA), the Electric Power Supply Association (EPSA), the Natural Gas Supply Association (NGSA), the American Petroleum Institute (API) and the Energy Marketing and Trading Group note many of the same problems with the proposed rule and raise additional issues that deserve the Commission's attention.

## II. Comments

### GLOBAL COMMENTS

The Commission Should Recognize the Scope of Commodity Merchants' Market Activities

A fundamental misconception that shapes many parts of the rule is the categorization of market participants into discreet segments: hedgers, speculators and swap dealers. In reality, some market participants, including energy commodity merchants, function in multiple segments of the futures, options and over the counter (OTC) markets in conjunction with their physical positions to create trading books that support their fundamentally physical businesses.

Commodity merchant/traders must efficiently optimize and hedge physical, futures, options and OTC positions within the confines of the risk tolerance of their firm. They are managing their book to limit risk and optimize economics. They are not placing "financial bets" on exchanges. This process does not lend itself to a matching between futures exposure and then-current physical exposure. If entities that need to manage their commercial risks are unable to efficiently hedge and optimize their businesses on regulated exchanges, they will need to find other vehicles. Therefore, a rule based around a preconception that commercial firms are pure "hedgers" (or designed to force related segmentation) could result in significant consequences, including a flight of transaction activity from US exchanges.

The Role of Financial Products in the Commodity Sector

Participants in commodity markets, almost by definition, have significant exposure to risks related to their physical positions, which can include natural resources that have yet to be extracted as well as materials that are being transported or processed (like oil in refineries) to stocks being held to meet peak demand, for example, natural gas held in storage facilities. This is true for both the suppliers of commodities as well as their consumers. There are numerous financial risks associated with buying, selling or holding commodities. These include differences in prices across locations, periods of time and product grades, as well as supply/demand related volatility; credit, weather, currency, interest rate and other macro-economic related risks. Financial products, including futures, options and swaps, provide cost-effective means for the participants in energy commodities markets to manage these risks.

Such hedging positions are not always in the same energy commodity. For example, market participants may use crude oil as a proxy for a number of other products, such as fuel oil. While there is a fuel oil swaps market, it is often not liquid enough to hedge an entire position. A trader may hedge what it can with fuel oil swaps and then put on a crude oil futures position to hedge the balance until the fuel oil swaps liquidity improves. In fact, non-energy commodities can be used to hedge energy positions as well, for example, gold may be used as a vehicle to hedge currency risk associated with energy commodities moved across international borders.

Parties that do not hold physical positions in underlying commodities, or take financial positions apart from their physical positions, are also critical to the efficiency of the derivatives market. Indeed, without the liquidity provided by these speculators and their willingness to take on risks, hedging would be more difficult and more costly.

The risk mitigation and reduction of price volatility offered by financial derivatives significantly benefits the US economy and US citizens by affording commodity producers, marketers and customers efficient mechanisms to lock-in reliable pricing and provide confidence that their businesses will not be impacted by unpredictable price volatility, which can have severe consequences, including bankruptcy. Reduced risks ensure that financial institutions will lend, and at the highest level, reduces systemic risk in the economy.

<u>The Trading Activities of Commodity Merchants</u>

A primary public benefit of financial derivatives markets is to provide firms that produce, market, use as a feedstock, and consume physical commodities with a liquid, transparent and reliable market to hedge risk, optimize value and discover price. Firms with material physical commodities exposure often employ trading desks that can manage the dynamic movements in supply, demand, and pricing for an ever changing variety of customers and suppliers. The one constant in a broad-based physical commodity-based business is that it is always changing due to variables such as weather driven volatility, business cycle related-demand volatility, supply volatility (which can be driven by global events) and numerous other factors.

A commodity merchant's trading desks manage the firm's overall dynamic physical position by understanding the risk to which the firm is exposed through its overall physical and financial position. The purpose of this activity is to manage risk and optimize economics. Given the dynamic nature of physical supply and demand positions coupled with price volatility, a trading desk is best situated to limit the risk to the firm's portfolio as a whole, rather than try to match physical supply to financial hedges on a transactional basis. Further, in order to be effective, a trading desk needs to be "in the market" to assure that it is truly tracking price and market dynamics. There is a material difference between a market observer and a market participant in understanding and anticipating market movements.

The NOPR fails to appreciate the breadth and depth of activity of the trading activities of commodity merchant/traders. Any proposal attempting to address the financial energy commodities market should be reflective of how market participants behave and interact with the market.

The proposed rule appears to stratify the energy derivatives market into three mutually exclusive categories: ("Hedgers" "Speculators" and "Swap Dealers") and then impose specific requirements and restrictions on each. In reality, this neat taxonomy does not exist. There are parties that use derivatives strictly for hedging. There are others that use them as a means to take speculative positions. There are also entities that act as market makers and enter into swaps with third parties as a primary part of their business. What the proposed rule does not recognize, however, is that there are entities, including physical commodity merchant/traders, that operate in all or at least portions of all these three capacities. The scheme for imposing position limits that is contemplated in the NOPR would fundamentally change the way that such entities operate in the financial products market.

This compartmentalized mindset is most apparent when one considers the proposed exemptions to the position limits. The proposed rules allow for *bona fide* hedge exemptions for entities that can demonstrate that their large physical positions require them to hold a sufficient number of futures and swaps to hedge their physical exposures. However, the proposed rule appears to prevent entities using hedge exemptions from holding any "speculative positions". As is explained below, this prohibition is both unprecedented and unwise. The necessity of allowing speculation in derivatives markets is well accepted, and is frequently articulated by the Commission. When they speculate, commodity merchants play an especially valuable role not only because they provide liquidity, but because their extensive involvement in the physical markets informs their trading activity which tends to move derivatives prices towards levels supported by economic fundamentals.

The NOPR also seeks to segregate speculators and swap dealers. Swap dealers can obtain "risk management" exemptions that allow them to hold positions equivalent to two times the default position limits; but they also are prohibited from holding any speculative positions. Moreover, the expansive definition of "Swap Dealer" appears to be intended to prevent entities with hedge exemptions or those that can speculate from being involved in the bilateral swap market. (As is described below, the proposed definition of "Swap Dealer" is highly problematic in its own right). The NOPR provides no explanation of dividing market participants into these artificial segments or how it meets the Commission's objectives. Nor does the NOPR discuss the treatment of entities that might fall into more than one classification.

The Commission Must Provide a Linkage Between Its Proposed Rule and Excessive Speculation to Satisfy the Statutory Standard For Federal Imposed Position Limits

As noted by the Commission, the Commodity Exchange Act (CEA) provides that it may fix limits on amounts of trading to address "excessive speculation in any commodity.... causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity" creating "an undue and unnecessary burden on interstate commerce in such commodity" Section 4a(a) of the CEA, 7 U.S.C. § 6a(a) (2006). Accordingly, in order to establish position limits for the four affected energy commodities, the Commission should associate the proposal to addressing excessive speculation that is the proximate cause of sudden, unreasonable or unwarranted price fluctuations.

Rather than focus on speculation in the proposed rule, the Commission has focused upon concentration. Although, the Commission notes that, "[l]arge concentrated positions in the energy futures and option markets can facilitate abrupt price movements and price distortions," NOPR, slip op. at 18, 75 Fed. Reg. at 4148, it does not provide any factual examples of such large positions resulting in price distortions or other detriments. In addition, while the Commission recounts the price rise in energy prices from 2007 to mid-2008, it does not show a linkage to excessive speculation and omits reference to its own staff report and other analyses of that period finding otherwise.[2]

In sum, the Commission has not meaningfully supported a linkage of its proposed rule to remediating excessive speculation. Instead, it focuses on concentration and implicitly suggests that large concentrated positions can facilitate price movements and distortions. The Commission appears to believe that concentration equals excessive speculation and there is no other measure or manner in which it can occur or be tracked.

These issues are addressed in greater detail in the Comments filed by the FIA and ISDA. Shell Trading agrees with and supports the comments of those groups on these issues and, in the interest of brevity, will not discuss them further in its comments.

## COMMENTS ON SPECIFIC ASPECTS OF THE PROPOSED RULE

The "Crowding Out" Provisions of the Proposed Hedge Exemptions will Create Significant and Unnecessary Changes in the Business Models of Commodity Merchants

As noted by several other commenters, the NOPR's unprecedented proposal to prevent many market participants from holding any speculative positions is of significant concern. The NOPR provides no explanation to justify this fundamental change in policy.

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2 The FIA comments filed in this proceeding on March 18, 2010 include reference to multiple contemporaneous studies finding price movements were not due to excessive speculation. *See, FIA Comments @ Footnote 7.*

The proposed rule provides for *bona* fide hedge exemptions upon application demonstrating need. While the NOPR does not address the critical function of administration of the exemptions, Shell Trading's business is fundamentally a physical business, and therefore, it would likely be eligible for *bona fide* hedge exemptions. However, if Shell Trading received hedge exemptions, the proposed rule would prohibit Shell Trading from holding any "speculative" positions.

> Traders holding positions outside the spot month, and traders holding spot month positions with respect to spot-month positions only, that are greater than or equal to a *bona fide* hedge exemption shall not own or control positions speculatively.

NOPR, slip op. at 90, 75 Fed. Reg. at 4169.

Shell Trading submits that this provision will not only inflict significant economic harm to it and other commodity merchants, it would reduce liquidity and weaken the critical price discovery function by limiting the activities of the most informed market participants. There is no justification for preventing entities that hedge large physical positions from having the same ability to enter into non-hedging transactions as other parties are allowed. The “crowding out” prohibition is a significant departure from the current practice of the exchanges. Further, as the Commission’s concern appears to relate to concentration, it would seem to be less relevant if there are some positions are held “speculatively.” As long as a market participant’s positions are within the allowed limits (including the hedge exemptions), it will not create unapproved concentration.

Much of the recent concern about speculators has been focused on the “massive passives”, entities that take and hold large long positions, simply betting that prices will increase. In contrast to hedge funds and other passive investors, commodity merchants actively manage consolidated physical and financial trading books made up of both long and short positions, identifying discontinuities between prices and fundamental conditions. In some situations this "speculation" may take the form of leaving physical positions unhedged. In others, it may mean entering into derivative transactions without the anticipation of taking offsetting physical positions. Regardless, the positions taken by commodity merchants reflect their in-depth understanding of physical supply, demand and global market conditions.

In this way, commodity merchants’ trading activities help keep market prices in line with fundamental economic conditions, allowing derivatives markets to provide accurate price discovery. Therefore, it would be especially poor policy to prevent them from holding speculative positions.

Even putting aside the unjustified harm caused by this prohibition, the proposed rule presents almost insurmountable compliance issues. It is extremely difficult to separate speculative positions and hedges. Any lot of a physical commodity might be subject to multiple hedges related specifically to it, but is likely also subject to hedges related to a commodity merchant’s entire portfolio of that product or other products. Hedges may be entered into in contemplation of production that does not occur or cargoes that are diverted. When such events occur (as they frequently do) the positions that were taken should not, in hindsight, be considered to be "speculative".

For example, a business can have a physical exposure to transatlantic freight prices. The freight swaps market is a highly illiquid, relatively immature market making it very improbable the business can hedge its freight exposure in a forward freight swaps market. The WTI vs. Brent spread moves relative to the changing refining economics of Brent-based crudes in the US but it will also tend to rise as transatlantic freight costs rise and fall when those costs fall. If a business hedges its freight costs by buying WTI and selling Brent using the oil futures or swap markets would the rule recognize that as a hedge or speculating on the oil market or both?

Another example might be a power marketer that owns a natural gas-fired generation facility and desires to hedge its exposure to fluctuating power prices. Because gas is the fuel used to generate the power, the power marketer could sell a gas swap to hedge its physical position. However, if weak demand or low power prices require the plant to stay offline, and not produce electric energy, the marketer would still hold its natural gas swap position. Is this still hedging or has this position now become speculative? If it is considered to be speculative, the marketer might have to liquidate the swap at a time that could result in additional revenue loss.

For these reasons, Shell Trading requests that the Commission modify its proposal to allow entities with *bone fide* hedge exemptions to hold speculative positions, consistent with other market participants, and further that the Commission clarify its definition of "*bona fide* hedge" to recognize the dynamic nature of the trading activities and make clear that hedging of physical positions includes trading related to the commercial risks and economic optimization of portfolios of physical commodities.

<u>Position Limits</u>

Shell Trading does not oppose reasonable position limits, such as those in place today, that specify the maximum net number of an exchange-traded derivative contracts that an entity can hold on a US exchange; however, it has several concerns with the overall set of limits proposed in the NOPR, including its reliance on possibly unnecessary contract "classes" (see below) and the lack of clarity about how some of the proposed limits would be calculated. For example, how would the "delta-adjusted month-end open interest" be derived?

Shell Trading also has practical concerns with how the limits would be developed and enforced. In particular, there are significant potential issues with how the proposed limits interact with themselves and with existing exchange limits. For example, in the spot month, the proposed rule would impose its own single exchange limits on top of the existing limits maintained by each exchange. Moreover, it appears that both types of limits are based on the same information. Little value will be obtained from adding a duplicative set of limits.

For “any month” and “all months” positions there will be both single exchange and aggregate exchange limits. With the creation of the aggregate limits, the role of the single exchange limit is unclear. As long as the position held by an entity was below the aggregated limit, why would it be important whether that position is held on one or multiple exchanges? Additionally, it is unclear how these new position limits would interact with existing exchange accountability limits.

The uncertainty about the mechanics of the limits presents significant compliance risks that may prompt market participants to take a cautious approach by maintaining positions well below the limits. The result would be a reduction in liquidity and a movement towards off-exchange transactions. Because the proposed limits are based on a percent of open interest, as transactions move away from the exchanges, the limits will contract further, creating a downward spiral that will exacerbate this effect.

Additionally, the NOPR does not specify who will be responsible for the daunting task of monitoring and enforcing the aggregate limits. Under exchange-based limits, exchange compliance personnel can monitor positions on their exchange and interface with traders, as they do today. Unless the Commission plans to take over position monitoring or merge exchange compliance teams, there will be a gap in monitoring of aggregated positions.

For these reasons, Shell Trading recommends that the Commission reevaluate the proposed limits with an eye towards simplification, enforceability and clarity. The Commission may want to eliminate the use of aggregate limits in favor of one set of single exchange limits, which would provide clarity, allow exchange compliance staff oversight, and eliminate Foreign Board of Trade issues and ambiguity.

Contract Classes and Aggregated Limits

Shell Trading questions the need to establish separate classes of contracts (Physical Delivery and Cash-Settled). As a practical matter, both types of contracts cash-settle, and, as such, are not meaningfully constrained by physical delivery limitations. The segregation into different classes subject to different limits would create unneeded complexity and could lead to unforeseen consequences. As the contracts have the same underlying commodity and are economic substitutes to one another, differentiating among them could lead to differentiated trading and market distinctions based solely upon "class" and associated position limits – not on any substantive difference.

Also, it is only because of the class distinction that there is a need to utilize the concept of "Deliverable Supply." If, like contracts, whether physical or financial, were subject to a single position limit based upon open interest, then the equivalent economic instrument (for example, NG Physical Delivery NYMEX & NG Cash-Settled NYMEX futures) would be collectively subject to the same position limit, which could be established from the objective measure of open interest. There would be no reason to define and specify "Deliverable Supply."[3]

Thus, Shell Trading believes that any position limits should be designed to cover like contracts which are effectively the same economic instrument whether taking the form of a notionally physically delivered contract or a cash-settled contract. This approach would permit traders to simplify compliance and the Commission to use a straightforward measure to establish limits (open interest).

Aggregation of Affiliate Positions

Shell Trading shares the concerns voiced by other commenters regarding the problems associated with aggregating the contract positions of all entities that have common ownership of 10 percent or more for purposes of applying position limits. Although it might be appropriate to aggregate the positions of entities that are under common ownership and control and that coordinate the management of their derivatives positions, in the case where there is independent control, no aggregation is appropriate. Shell Trading supports the comments of ISDA and FIA regarding the account controller exemption for position limits that currently exists in Regulation 150.3(a)(4).

Treatment of Foreign Boards of Trade (FBOTS)

As noted by the Commission, FBOTs accommodate contracts which cash-settle to NYMEX physically settled energy futures contracts. These FBOTs operate subject to Commission no action letters, which are conditioned in part, upon a requirement that the FBOT implement the position limit requirements that NYMEX contracts are subject to. The Commission states such linkage is necessary to "ensure the integrity of prices for CFTC regulated contracts." NOPR, slip op. at 3, n.3, 75 Fed. Reg. at 4144.

Shell Trading believes that the Commission should directly address the treatment of FBOTs in its proposed rule. Unlike the current structure with exchange-based limits, the proposed rule covers aggregate positions across like contracts across all exchanges. If an FBOT includes like contracts, will positions on that exchange be aggregated? As the position limit is a function of open interest, will the FBOT's open interest be included? If the FBOT does not set its rules in accordance with Commission requirements, will the Commission revoke its no action letters?

As it is more likely that FBOTs will add more contracts rather than cease trading those traded today, it is essential that the Commission provide clarity on these critical points.

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[3] If the Commission proceeds with the notion of Deliverable Supply, Shell Trading believes the Commission should give guidance and define the term. Issues to be addressed should include: Is this definition limited to the precise specified product and delivery point in a physically delivered contract? Does it include any substitutes? Does it vary by month? Is Deliverable Supply different under differing demand and or pricing scenarios? and does it include only domestic supply and pipeline capacity, or does it envision the practical reality of imports?

This necessity is magnified by the fact that firms may be affiliated with non-US entities that trade on FBOTs. Will the proposed rules consolidated account requirement apply to firms trading only on FBOTs? The Commission should not move forward towards a final rule without clearly and decisively addressing issues related to like contracts traded on FBOTs. Until the Commission clarifies its intentions, parties cannot understand the legal underpinnings of the Commission's plans to be involved in FBOT practices, and therefore cannot meaningfully comment. If the Commission were to limit its proposal to one set of single exchange limits, there would be no need to further address FBOTs, and no aggregation of positions potentially affecting FBOTs would be implicated.

Reporting Requirements

While Shell Trading believes reporting can help improve transparency and regulation of derivatives markets, the reporting aspects of the proposed rule require further development.

An important element of the proposed rule is reporting and tracking of positions. While reporting is addressed at a high level and forms (such as Form 404) are referenced, there is little specificity indicating the particular information to be provided. For example, a trader must submit its "spot and forward positions priced in relation to the relevant energy contract or the contract's underlying commodity." NOPR, slip op. at 53, 75 Fed. Reg. at 4159. It is unclear what data is required (Is this limited to exchange traded contracts? If so, shouldn't the pricing relate to the exchange traded price? If this requirement extends beyond exchange-traded contracts, what is the scope of the data requested?)

As Form 404 has not yet been developed, parties have not been provided a meaningful opportunity to comment on its contents. As it appears to be a significant element of the data collection aspect of the proposed rule, the scope of data sought, the form in which it will be submitted and the associated burden are very unclear. The Commission has estimated 800 hours of effort by regulated firms to complete the report. As new computer systems will almost certainly be needed to create the data requested, our experience suggests that the effort to comply will almost certainly be much greater (at least at the outset).

Shell Trading is also concerned that the data requested may include its proprietary overall physical and financial positions. If this highly sensitive commercial data is sought, the Commission must provide a clear process showing that the data will be treated confidentially and protected against inadvertent disclosure and FOIA inquiries. In order to limit the potential exposure of proprietary commercial data, Shell Trading encourages the Commission to create a Form 404 that limits the amount of proprietary data requested.

Definition of "Swap Dealer"

As discussed above, Shell Trading believes that it is ill advised to segment the derivatives market into artificial categories such as "swap dealers". It is certainly unnecessary to do so in this rule. Entities that qualify for the "limited risk management" exemption should be allowed to regardless of a "swap dealer" label. Accordingly, Shell Trading recommends that references to "swap dealer" be omitted from the proposed rule. Should the Commission elect to retain this concept, however, the proposed definition must be substantially revised.

Section 151.1 of the proposed regulation would define swap dealer as

> "any person who as a significant part of their business holds itself out as a dealer in swaps, makes a market in swaps, regularly engages in the purchase of swaps and their resale[4] in the ordinary course of business or engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps."

NOPR, slip op. at 86, 75 Fed. Reg. at 4168.

This definition, as written, is so vague as to be meaningless. Per the definition, a "swap dealer" is a dealer in swaps; makes a market in swaps; or is called a swap dealer by those in the "trade." "Dealer", "market maker", "significant" and "trade" are not defined. In effect, the definition could be construed to apply to virtually any party party to a swap on the basis of the subjective opinion of an unknown group of individuals in some undefined "trade".

If the Commission desires to designate a category of market participants considered "swap dealers," Shell Trading suggests it construct a clear definition indicating what criteria and activities merit this status. There should be no potential that commercial merchants such as Shell Trading be considered a swap dealer. As Shell Trading understands it, a swap dealer is a financially-based firm that is not exposed to physical risk but rather acts as counterparty to swaps as a principal part of its business, and actively makes bids and offers. It may require access to futures and options markets to hedge the financial risk of its non-physical swap book. The fact that a predominately physical commodity merchant is counterparty to swaps should in no manner make it a swap dealer.

Consequences of Ambiguity in the Proposed Rule

Like many companies in today's energy industry, Shell Trading makes regulatory compliance a top priority. It takes a conservative approach to compliance assurance. The proposed rule contains many ambiguities relating to items such as: the "crowding out" proposal; the interplay between the existing exchange-based position limits and the

[4] In practice, swaps are not "purchased and resold".

proposed single exchange and aggregate limits; the consolidation of affiliates; data reporting and the calculation of deliverable supply among others, Shell Trading is concerned that a likely effect of this complex and unclear proposal will be for market participants to intentionally maintain positions well under the limits even if that means they will need to move away from regulated exchanges to other risk management vehicles. The outcome of this transfer will be to reduce liquidity on regulated exchanges, increase costs as less efficient and riskier risk management tools are employed, and potentially move trading offshore. None of these outcomes is beneficial to the US economy, markets or consumers.

## III. Responses to Questions Requesting Comment

Based on the positions described above and its experience in energy derivatives, Shell Trading provides the following responses to certain of the questions posed by the Commission in the Notice of Proposed Rulemaking.

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

As noted in Shell Trading's comments above and in the preamble to the proposed rule, the CEA speaks of "excessive speculation," not position concentration as a potential burden on interstate commerce. The Proposed Rule is not designed to prevent excessive speculation. Shell Trading believes that properly designed and implemented exchange position limits can prevent undue concentration.

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

Shell Trading does not believe new limits are needed to address "burdens" related to speculation; however, an alternative to position limits would be to follow a practice currently used effectively by the exchanges—adjusting initial margin rates. In other words, instead of imposing an outright limit on the positions held by an entity, the exchanges could require higher initial margin requirements for entities holding higher percentages of open interest e.g. : 0-5 % of open interest - standard initial margin rates; 5-10% of open interest - a higher margin rate; above 10% - yet a higher rate. These increasing cash requirements would strongly discourage entities from taking unnecessarily large positions. This approach would tend to discourage speculation. It would require speculators to put more capital up to speculate. The more speculation, the more capital will be required, creating a disincentive to excessive speculation.

**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?**

Problematic position limits have a damaging effect on liquidity, market efficiency and price discovery capability. Shell Trading believes that elements of the proposed rule may lead to the migration of risk management off-exchange. This movement will tend to reduce liquidity, market efficiency and negatively impact price discovery.

**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?**

Please see comments above relating to the elimination of class distinctions.

**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.**

The need for position limits is more related to assuring the orderly function of the market than to restraining "excessive speculation". Thus, the proposal set out in this question is unlikely to impact excessive speculation. However, should the Commission set federal position limits, using a rolling six month average of open interest as a basis for those limits is worthy of further consideration because it would dampen the impact of seasonality and limit the effect of unexpected market events.

**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.**

As noted above, Shell Trading believes that limits should be applied on an exchange basis. In no case should there be duplicative CFTC and the exchange limits. As a practical matter, a market participant will always seek to maintain its positions below the lower limit, making the higher limit unnecessary.

**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?**

Imposing the type of position limits proposed in the NOPR on FBOTs raises legal and practical issues. For example, if "open interest" included the open interest on all exchanges, the chance of a single entity actually exceeding the limit is smaller because the denominator of the equation will increase as additional contracts are added. For these reasons, Shell Trading recommends that new position limits not be imposed on FBOTs.

**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.**

Future statutory changes may necessitate changes in this regulation and all other agency rules. There is no certainty regarding the form and timing of legislation that would impose regulations on OTC derivatives and FBOT contracts. Accordingly, this rule should either be designed to operate under current law or the Commission should wait until new legislation is enacted to issue rules related to position limits. In no case should the final rule be based on a guess of the form of future legislation.

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

> **a. Should spot-month position limits be set on a more frequent basis given the potential for disruptions in deliverable supplies for referenced energy contracts?**
>
> No. Exchanges currently have an effective mechanism for handling special events and situations relative to spot month. This is done by raising and lowering initial margin rates.
>
> **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?**

Notwithstanding our objections related to the proposed position limits described in Shell Trading's comments, some form of rolling average would provide for an orderly adjustment of limits over time. A rolling 6 month average might be appropriate because it would dampen seasonal cycles, but is short enough to reflect current (rather than historical) market conditions.

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

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

The definitions related to contract "classes" are needlessly complex. Shell Trading does not believe that the physically-settling and cash-settling instruments should be put in different classes. As a starting point, we recommend using the current NYMEX "rollups" as a means to group contracts for this purpose.

Although it does not appear to be an issue with the contracts currently proposed for limits under this regulation, care should also be taken to avoid grouping together contracts based on different products, for example, different grades of oil.

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

No. The exact expiry date is not important. The commonality of the underlying commodity is the key.

**17. Under the proposed regulations, a swap dealer seeking a risk management exemption would apply directly to the Commission for the exemption. Should such exemptions be processed by the reporting markets, as would be the case with *bona fide* hedge exemptions under the proposed regulations?**

Yes, they should. Ideally, all exemptions should be handled under a single process.

**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?**

As indicated above, Shell Trading believes that the Commission can eliminate the need to estimate Deliverable Supply by simplifying its approach to contract classes. It the Commission elects to retain a structure that requires estimates of Deliverable Supply, it should better define that term. Then, the best means of estimating Deliverable Supply can be determined.

## IV. Conclusion

For the reasons described in its Comments, Shell Trading is concerned that the proposed rule could impair the efficient operation of the US exchange-traded energy derivatives market without providing the benefits intended by the Commission. The results could include higher costs, reduced liquidity, and greater compliance risks and costs, all of which would encourage market participants to move their activities to OTC products and offshore markets. If the Commission continues to pursue the development of federal position limits, Shell Trading recommends that it issue a revised NOPR that addresses the concerns raised by Shell Trading and other commenters.

Most important, Shell Trading urges the Commission to avoid the approach of segmenting market participants into discreet categories for purposes of restricting the types of positions they hold or the size of those positions. The categories of market participants contemplated by the NOPR are not reflective of the activities of many market participants. Prohibiting companies using hedge exemptions from holding speculative positions would needlessly reduce liquidity and prevent commodity merchants--the entities that have the strongest knowledge of supply and demand fundamentals--from fully contributing to price formation. Should federal position limits be created, Shell Trading recommends that they should be as simple and well-defined as possible, avoiding situations where both exchange-set and CFTC limits are applicable to the same position. Shell Trading's comments have noted many areas in the proposed rule that require clarification. In particular, clarity on the application of the limits and on reporting requirements is a prerequisite to the ability of market participants to comply with the new rule. It is also important that a revised NOPR clearly state the Commission's intentions regarding the aggregation of positions held by affiliates and the application of new position limits to FBOTs. An understanding of the Commission's expectations would allow affected parties to meaningfully comment on those critical issues.

Again, Shell Trading appreciates the opportunity to provide these comments. We will be pleased to provide additional information regarding our views on the regulation of energy derivatives, and would welcome the opportunity work with the Commission to develop an approach to meeting the Commission's objectives regarding excessive speculation and concentration while maintaining the liquidity and efficiency of today's energy derivatives markets.

Respectfully submitted,

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cc: Chairman Gensler
Commissioner Dunn
Commissioner Chilton
Commissioner Sommers
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