

**From:** Patrick Kelly <kellyp@api.org>  
**Sent:** Monday, April 26, 2010 10:14 AM  
**To:** secretary <secretary@CFTC.gov>  
**Subject:** Proposed Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations  
**Attach:** Proposed Federal Speculative Position Limits API Comments.pdf

---

<<Proposed Federal Speculative Position Limits API Comments.pdf>>  
David Stawick,

Re: Proposed Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations

API comments to the above referenced proposed rule were submitted today via [www.regulations.gov](http://www.regulations.gov). For your convenience, I am also sending this email with our comments attached.

Regards,  
Patrick Kelly  
API



**Patrick Kelly**  
Policy Advisor

Fuels Issues, Downstream

1220 L Street, NW  
Washington, DC 20005-4070  
USA

Telephone 202-682-8192

Fax 202-682-8051

Email [kellyp@api.org](mailto:kellyp@api.org)

[www.api.org](http://www.api.org)

April 26, 2010

David Stawick  
Secretary  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21<sup>st</sup> Street, NW.  
Washington, DC 20581

Submitted via: <http://www.regulations.gov>

**Re: Proposed Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations (Docket ID: CFTC-2010-0004)**

Mr. Stawick:

API is a national trade association representing approximately 400 member companies involved in all aspects of the oil and natural gas industry. Our members actively trade the financial products covered by this proposed rule and will be impacted by a final rule. While API supports transparency in the marketplace, we remain concerned that the technical justification for this proposal may not be adequate. API appreciates the opportunity to comment on this proposal.

Our members are concerned that their bona fide hedging activities will be negatively impacted by this regulation. It appears this is not intended, and we hope this issue can be addressed. API is also concerned about the unintended consequences that may impact the overall marketplace, specifically the migration to overseas markets. This would serve to decrease transparency in the marketplace.

It is important to note that speculators are not manipulators. API supports the pursuit and prosecution of market manipulators. Parties that impact the market however, are not inherently manipulating the market. Speculators provide liquidity and market information that help to establish prices. Speculators are often better suited to absorb price risks than their counterparties. These functions of risk management and price discovery are core purposes of the exchanges, and rely on the participation of speculators.

### **Hedge Exemption Provision**

API member companies often make use of existing bona fide hedge exemptions in the proposed commodity classes. Compliance challenges from the proposed "crowding out" provisions are therefore relevant and warrant CFTC reconsideration, as well.



### “Crowding Out”

Under the Proposed Rule, the CFTC would authorize the granting of two types of exemptions from the position limits for the referenced energy commodities: bona fide hedging exemptions, which are also applied to agricultural commodity limits for traders with hedging needs, and the new limited risk-management exemption for swap dealers, for positions held outside the spot month. The exchanges will continue to be authorized to grant bona fide hedge exemptions to traders for commercial hedging, subject to the authority of the CFTC. Swap dealers would be permitted to apply for hedge exemptions for their commercial hedging needs, in addition to any risk-management exemptions granted by the CFTC.

Regardless, though, of whether a company is ultimately classified as a bona fide hedger or swap dealer, it would be prohibited from holding any position in excess of the applicable position limit if it has any speculative positions. While the Proposed Rule provides for risk-management exemptions up to two times the proposed position limit, as well as hedging exemptions that would allow a swap dealer to go beyond this elevated position limit, the Proposed Rule effectively eliminates the benefits of higher limits for any hedger or swap dealer that has any speculative positions, even at a minimal level. As a result, once such a company has exceeded the position limit, regardless of whether it has an exemption from the position limit, it must liquidate all of its speculative holdings, if such holdings can even be segregated, or bring its hedging or risk-management positions below the position limit.

As a result, the Proposed Rule could severely limit the hedging activity of energy companies who engage in swap trading for purposes of risk management. Whether classified as a commercial hedger or swap dealer, many API companies engage in swap activity as part of their overall risk management for refining and the marketing of physically produced commodities. By limiting speculative transactions when combined positions (speculative and hedging and/or risk management) exceed the applicable position limit, the Commission will in turn significantly and adversely impact the trading opportunities of market participants and end-users to execute hedging and/or risk-management transactions. In addition, speculative activity by both commercial hedgers and swap dealers provide volume and liquidity to the markets, ensuring accurate price discovery and stability. For example, speculation will likely decrease in the outer months, adversely affecting commercial producers who use these contracts to lock in future prices. In turn, this will reduce the liquidity in the market, as market participants who hedge, manage risk for others and speculate will be subject to the hard position limit and limited in their use of exemptions. Any regulation that reduces liquidity in U.S. markets could push trading activity to unregulated OTC markets and foreign exchanges. Furthermore, it remains unclear how the CFTC and market participants will distinguish between purely hedging and risk-management transactions, compared to transactions that may have some speculative nature, which often could come down to a subjective judgment based on stated intent.

Finally, if companies are actually forced to even liquidate positions that *might* ultimately be deemed speculative, just to be safe in terms of regulatory compliance, this would actually subject these covered markets to greater instability, not less. Every time participants trigger their legitimate exemptions, they will be required to scramble to unwind all uncertain trades, consequently nullifying the value of the exemption for no corresponding policy benefit, since commercials by their very physical nature pose almost no risk of excessive speculation. The other compliance alternative would be to never even employ the offered hedge



exemptions, thereby subjecting the underlying physical markets to potentially greater risk and volatility, as well.

The Commission's position limit hedge exemption regime has always permitted a single market participant to establish speculative positions up to the applicable position limits and to obtain hedge exemptions, if eligible, for hedging positions above these levels. This practice has been based on the fact that hedging positions eligible for exemption, even if held by an entity that also maintains speculative positions, does not present the market concern that position limits are designed to mitigate.

### **Issues with company aggregation**

Under the Proposed Rule, the Commission would aggregate positions in accounts in which any person has an ownership or equity interest of 10% or more, or in a case in which a person controls trading by power of attorney or otherwise. The rule provides a notation for positions held as part of commodity pool or advisor business. Under such approach, the Commission would aggregate accounts by both owner and controller, eliminating the potential exemption for independently controlled positions. Independent trading control has been a recognized exception to aggregation by both the Commission and the CME Group in assessing aggregation of positions held in accounts of related entities.

The Commission's approach poses potential compliance issues on many levels. Aggregating positions across accounts based on equity interest will require information sharing across those entities on a real time basis in order to ensure appropriate positions are maintained in compliance with the provisions of the Proposed Rule. Such information sharing would be highly problematic within business structures in which independent entities are precluded from sharing information as dictated by the entities risk controls and compliance policies. Positions would need to be managed across separate entities, with volumes allocated across those entities. This aggregation would prove to be highly disruptive to the trading and compliance requirements of the related entities and would impose a substantial administrative burden on the entities. The Commission's proposal fails to address any such conflicts which may arise by information sharing across independently controlled, and operated, entities.

The Proposed Rule also fails to address the possible distinction between the classification, or business function, of the related entities. As an example one entity may be considered a bona fide hedger, while the other a swap dealer, each treated distinctly under the Proposed Rule with respect to exemptions, risk management activity and speculative positions (the "crowding out" provisions of the Proposed Rule). The Proposed Rule does not resolve how the rule provisions would be applied to such positions on an aggregate basis.

The Commission's Proposed Rule should provide an exemption from position aggregation related to equity ownership for independently controlled positions (unrelated to the referenced exception for advisor or commodity pool business). In allowing for such an exemption, the Commission would recognize that accounts operating under an arms-length relationship, independently functioning corporate entities with separate authorized traders, separate position control, separate risk control and separate management, should



not be aggregated as the positions cannot be viewed jointly in assessing potential impact on the marketplace.

### **Broad Market Implications**

Section 151.2 of the proposed regulations implements a methodology that is vastly more comprehensive than the present set of position limits. Speculation is not akin to market manipulation, and we recognize that speculators play an important role in commodity markets.

Subpart (f) is vague and does not ensure that the objective limits set forth in Subparts (a) through (c) are indeed fixed each year. Indeed, subparts (a) through (c) use the word "fixed" and subpart (f) uses the word "fix", enabling the fixing of limits that are very different from the objective limits set forth in subparts (a) through (c). So, what starts out as objective limit setting could end up as very subjective limit setting. This could be remedied by making clear in subpart (f) that the objective limits fixed in subparts (a) through (c) must be used in the final calculation of the limits each year.

Subpart (f) calls for the definitive calculation of an undetermined to date number, which may have a significant impact on the markets. The methodology to calculate estimated spot month deliverable supply should be delineated with specificity so the regulated community can readily understand and comment on it. The "fixing" to be done pursuant to subpart (f) is delegated to one person, or that person's designated staff without any stated guidelines and without publishing it in the Federal Register for public comment. This process should include an opportunity for notice and comment by impacted stakeholders. API is also concerned that the proposed prior notice of 30 days is not adequate for the market to properly understand the impact of the change and prepare for it.

The regulatory framework established in this proposal creates an expedient means to further ratcheting of position limits. Statements by Commissioners Chilton and O'Malia regarding this potential are especially concerning to API members.

API and our member companies appreciate the opportunity to comment on the proposal. For further information, please contact Patrick Kelly at 202-682-8192.

Regards,

A handwritten signature in black ink, appearing to read "Patrick Kelly".

Patrick Kelly  
Policy Advisor