From: Pantano, Paul <ppantano@mwe.com>
Sent: Monday, April 26, 2010 3:55 PM
To: secretary <secretary@CFTC.gov>
Subject: Proposed Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations
Attach: Morgan Stanley Comment Letter.pdf

Dear Mr. Stawick:

Attached are the comments of Morgan Stanley in the rulemaking proceeding noted above. Please contact us if you have any questions.

Respectfully submitted,

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Morgan Stanley

April 26, 2010

Via E-Mail: secretary@cftc.gov

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

Re: Proposed Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations, 75 Fed. Reg. 4144 (January 26, 2010)

Dear Mr. Stawick:

Morgan Stanley appreciates the opportunity to comment on the Commodity Futures Trading Commission's ("CFTC" or "Commission") Notice of Proposed Rulemaking concerning Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations, issued on January 26, 2010.[1] Morgan Stanley respectfully submits these comments primarily to address the adverse impact that the Proposed Rule would have on the ability of energy market participants, including Morgan Stanley and other financial and energy businesses, to manage the complex risks associated with physical and financial energy transactions and investments.

As Morgan Stanley demonstrates below, the Proposed Rule does not accommodate critically important commercial transactions and investments in energy products, services and infrastructure. For this reason, Morgan Stanley respectfully urges the Commission not to adopt the Proposed Rule. Instead, the Commission should rely upon its existing reporting requirements and market surveillance structure, which together have been effective in preventing excessive speculation in the energy commodity futures markets. The Commission should enhance those requirements before adopting the substantial changes set forth in the Proposed Rule. Furthermore, because Congress is considering legislation that substantially would amend the Commodity Exchange Act ("CEA"), including provisions that would affect speculative position

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[1] 75 Fed. Reg. 4144 (January 26, 2010) (with respect to the notice of proposed rulemaking, the "NOPR" and with respect to the proposed regulations, the "Proposed Rule").

limits for the referenced energy contracts, the Commission should refrain from taking any further action in the proposed rulemaking until Congress completes its work.[2]

I. Morgan Stanley Has A Significant Interest In The Proposed Rule

Morgan Stanley is a highly-diversified, global financial services firm that, through its subsidiaries and affiliates, including Morgan Stanley & Co. Incorporated ("MS&Co."), Morgan Stanley Capital Group Inc. ("MSCG"), Morgan Stanley Investment Management Inc. ("MSIM") and Morgan Stanley Smith Barney LLC ("MSSB LLC"), provides risk management and investment products and services to a large and diverse group of clients and customers. As a financial services firm, Morgan Stanley's businesses participate in many industries ranging from energy to healthcare, communications, retail commerce, real estate, and emerging technologies. Morgan Stanley's clients include some of the largest global institutional investors, commercial producers and industrial users of physical commodities, small businesses and private individuals.

Morgan Stanley has many affiliates that rely on the commodity futures markets. For example, MS&Co. and MSSB LLC are both futures commission merchants ("FCMs") that trade commodity futures contracts on behalf of clients. FCMs provide their customers and the futures markets with a number of critical services in addition to trade execution and reporting. For example, as exchange clearing members, FCMs provide the capital that makes possible centralized clearing of listed derivatives transactions and that will be critical to efforts to expand clearing services to more products, such as over-the-counter ("OTC") derivatives. Morgan Stanley affiliates also have interests in a number of commodity trading advisors and commodity pool operators. These entities manage assets and offer investment management services to a diverse client base that includes governments, institutions, corporations, and individuals. From time to time, some of these clients and funds may need to use energy futures contracts to hedge the price risks associated with energy-related assets that they may own, manage or acquire.[3]

Finally, for more than 25 years, Morgan Stanley has invested substantial time, talent and capital to develop its energy commodities businesses. Through MSCG, Morgan Stanley provides physical supply and offers a wide range of risk management products and services to producers, processors, merchants handling, and commercial users of energy commodities. To manage the risks associated with its energy business, Morgan Stanley takes positions in the spot,

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[2] Morgan Stanley supports the comments filed by the Futures Industry Association, Inc. ("FIA") and the International Swaps and Derivatives Association, Inc. ("ISDA") concerning the legal and other issues of the Proposed Rule. Letter to CFTC from John Damgard, President, FIA, dated March 18, 2010; Letter to CFTC from Conrad P. Voldstad, Chief Executive Officer, ISDA, dated April 16, 2010.

[3] On page 2 of the March 4, 2010, comment letter filed by the Institute for Agriculture and Trade Policy ("IATP"), IATP asserts incorrectly that in March of 2008, along with another firm's funds, the "Morgan Stanley index funds controlled 1.5 billion bushels of Chicago Board of Trade corn futures contracts." The IATP's assertion is materially inaccurate in several respects. First, Morgan Stanley does not manage any funds that fit the IATP's description of "Morgan Stanley index funds." Second, as a result of position reporting, the Commission and its staff are fully aware of Morgan Stanley's commodity futures positions. The Commission knows, therefore, that Morgan Stanley's Chicago Board of Trade ("CBOT") corn futures contract position in March 2008 did not even remotely approach the size asserted by the IATP. Because the IATP's assertion about Morgan Stanley's CBOT corn futures position in March 2008 is patently incorrect, we trust that the Commission will not consider the IATP's comments about Morgan Stanley in its deliberations about the Proposed Rule.

forward, futures and OTC derivatives markets for energy commodities, including crude oil, natural gas, electricity, and petroleum distillates, such as gasoline and heating oil. Morgan Stanley's presence and expertise in the physical and financial energy markets enable it to provide oil and natural gas producers, governmental entities, refiners, airlines, petrochemical companies, railroads, utilities, investors and other commercial clients with high-value, cost-effective risk management solutions (such as customized hedging programs relating to production, consumption, and reserve/inventory management) and structured transactions (such as the monetization of energy-contracts). Morgan Stanley's energy clients rely on these risk management products and services to conserve capital and to reduce the risks associated with operating their commercial businesses. Through MSCG, MSIM's funds, and other affiliates, Morgan Stanley also is an active and substantial investor in assets for the production, storage and distribution of energy commodities, and in energy sector infrastructure projects.

Morgan Stanley relies extensively on the commodity futures markets to hedge the risks associated with the broad array of risk management products and services that it provides to its clients, and with its own energy commodities assets. Because Morgan Stanley depends upon the efficiency and price discovery function of U.S. commodity futures markets, it strongly supports the Commission's market surveillance and enforcement efforts to ensure that commodity futures markets remain fair and orderly.

Based upon a careful review of the Proposed Rule and our extensive experience as an active user of futures contracts and OTC derivatives to manage price risk, we believe that the Proposed Rule will have a substantial negative impact on the energy markets. In particular, the Proposed Rule will directly and unreasonably limit the risk management services that Morgan Stanley and similar companies can provide to commercial enterprises and investors. Furthermore, the Proposed Rule may inhibit the ability of Morgan Stanley, its funds, and many of its clients from entering into hedging strategies that would enable them to invest in energy and related sector assets, including much-needed energy infrastructure and renewable energy projects. As a result, Morgan Stanley is submitting these comments on behalf of itself, its funds, and its clients to express its concerns about the Proposed Rule.

II. Summary Of Morgan Stanley's Comments

In the NOPR, the Commission proposes to: (1) implement new speculative position limits in certain energy futures and options on futures contracts; (2) preclude commercial hedgers and swap dealers from taking speculative positions if they rely upon the proposed exemptions; (3) treat risk management positions differently from bona fide hedge positions; and (4) require aggregation of positions in accounts of affiliated companies that share a ten percent or greater common ownership. The Commission's stated goal in proposing these substantial changes to the current regulatory treatment of energy futures contracts is to "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."[4]

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[4] 75 Fed. Reg. 4144 (January 26, 2010).

Morgan Stanley respectfully submits that the Commission should not issue the Proposed Rule for the following reasons:

- The Proposed Rule prevents an integrated financial and energy services company, *i.e.*, a firm that includes both a commercial energy and an OTC energy derivatives business, that relies on a bona fide hedge exemption in a spot month or risk management exemption, from taking a single speculative position. The restriction is unworkable because it would require hedging firms operating in a dynamic energy market to demonstrate that every futures contract position in a complex transaction portfolio containing physically settled spot and forward transactions, inventories of physical commodities, and OTC derivatives, is a hedge position intended to protect against adverse price movements of some other position. Moreover, the Commission should refrain from issuing a rule that, due to the "crowding out" provision, has the practical effect of prohibiting hedgers from entering into futures positions which the Commission has determined do not constitute excessive speculation when entered into by speculative traders.

- While the stated goal of the Proposed Rule is to diminish or prevent excessive speculation, it will actually prevent an integrated financial and energy services company from hedging the risk management contracts that it provides to producers, processors, merchants, and commercial users of energy commodities. By placing an arbitrary limit (two times the speculative position limit) on the size of a swap dealer's hedge position, the Proposed Rule will have the unintended, yet demonstrable, effect of reducing the number of entities that can provide these important risk management services and unnecessarily limiting the capacity of liquidity providers. The resulting difficulty and increased expense for commercial and municipal enterprises to hedge risk, particularly in less liquid contracts and markets, will increase energy costs for wholesale energy companies and their retail customers. Thus, the Proposed Rule could exacerbate already difficult access to capital and adversely affect the financial condition of many of these enterprises.

- Uncertainty about the future size of position limits will make commercial enterprises unsure of whether they have sufficient flexibility to hedge their long-term price risks. Without this certainty, they will have difficulty attracting long-term investments to develop or upgrade much needed energy assets and related sector assets, including infrastructure and renewable energy projects.

- The Commission's proposal to require aggregation of positions based solely upon a 10 percent ownership test will further reduce the ability of many market participants, including Morgan Stanley, to offer risk management contracts and services to their clients and hedge their physical energy positions. The Commission did not explain why it proposes to abandon its longstanding policy of allowing exchanges to aggregate energy positions based upon actual control over trading. Without separate exemptions for separately-controlled affiliates, the position limits will be insufficient to allow many market participants to hedge the total risk of their physical and swap position. Thus, affiliated market participants seeking to hedge the price risks of their

physical energy and risk management positions may have no choice but to rely more on the OTC derivatives and foreign futures markets.

- The Proposed Rule is not necessary to prevent excessive speculation. The Commission can prevent excessive speculation more effectively and with less disruption to the market by using and enhancing its existing authority. For example, the Commission can increase the frequency of its current Special Call on swap dealers and commodity index traders from a monthly to a weekly basis. In addition, the CFTC can implement and administer accountability rules that apply across multiple trading platforms. These enhancements would ensure that the CFTC has the tools that it needs to address market congestion or possible excessive speculation, but also would allow energy market participants to have continued access to critically important risk management contracts.

- Congress is considering amendments to the CEA that likely will affect the Proposed Rule. In order to avoid wasting substantial public and private time and resources, the Commission should wait until after Congress acts before considering the need for new position limits rules.

III. The Proposed Rule Will Substantially Disrupt Well-Functioning Energy Markets

Morgan Stanley respectfully submits that the following aspects of the Proposed Rule will reduce the ability of the most credit-worthy and sophisticated companies to provide important risk management contracts and services to energy market participants and to invest in critical infrastructure projects:

- the prohibitions against hedgers holding a speculative position in a spot month or risk managers holding a speculative position within a risk management exemption;

- the disparate treatment of commercial hedging and risk management transactions;

- the uncertainty about the size of position limits in the future; and

- the aggregation of positions of affiliated companies without regard to whether their futures positions are commonly controlled.

The Proposed Rule will have widespread unintended consequences. For example, certain types of important energy risk management transactions may be either impossible to obtain or more costly and less efficient under the Proposed Rule, particularly when market participants are experiencing financial difficulties or when energy markets are volatile or distressed. As a result, the Proposed Rule may well increase systemic risk without preventing excessive speculation.

A. By Restricting Hedge And Risk Management Exemptions, The Proposed Rule Will Substantially Disrupt Commercial Business In The Energy Markets

The Proposed Rule prohibits a hedger from holding even one speculative contract once the hedger relies on its exemption to exceed the proposed speculative position limit in the spot

month or a risk management exemption in the all months combined ("AMC") or single month limits. Thus, the purpose of the restriction is to "crowd out" any speculative trading from hedge-exempted positions. This is a significant and unwarranted departure from longstanding Commission and exchange interpretations that permit those with hedge exemptions to hold speculative positions up to the speculative limit. The Commission has provided no explanation as to why it is necessary to depart from its prior practice and impose materially different and more restrictive rules in the energy futures market.

Ironically, while the CFTC's proposal prohibits commercial hedgers and swap dealers from holding a speculative position within a hedge or risk management exemption, it allows pure speculators to hold positions up to the full level of the limits. Thus, such speculative positions equal to or lower than the proposed limits effectively would not be deemed "excessive." The Commission should refrain from issuing a rule that has the practical effect of prohibiting hedgers from entering into futures positions that the Commission has determined do not constitute excessive speculation.[5]

The "crowding out" provisions of the Proposed Rule are impractical because a perfectly-hedged transaction portfolio, without a single speculative futures contract position, is very difficult, if not impossible, to maintain. Because positions are not static, futures trades initially executed as hedges may not remain hedges for the entire duration of the underlying contract. If the hedged position expires, or is booked out, cancelled or terminated as a result of a default, the corresponding futures position arguably is no longer a hedge, at least not for the original transaction. Yet, the company's overall transaction portfolio may still be flat. For example, if a swap dealer agrees with its counterparty to terminate a swap early, it may not be possible immediately to liquidate the original hedge position in the futures market. Similarly, in conducting a global business, a swap dealer may agree with a counterparty in Asia to terminate an existing swap at a time when the NYMEX markets are closed or when there is little or no liquidity. The swap dealer may have to wait until the following day's session to liquidate the futures position that constitutes the hedge. Under the Proposed Rule, when the swap is terminated, the futures position may be viewed as a speculative position that could violate the swap dealer's risk management exemption. If the Commission were to implement the Proposed Rule, the Commission would need to provide guidance to market participants on whether exceeding the position limits under these types of circumstances would be considered a violation of Section 4a(a).

Furthermore, as described below, managing a complex portfolio of physical and financial energy transactions, including options, in different commodities with different product specifications, different delivery points and different tenors does not involve simply executing a

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[5] In its comment letter to the Commission, the FIA addresses the question of whether the Commission's proposal exceeds its authority under Section 4a(a) by prohibiting speculation that would not be "excessive." ("In Section 4a(a), Congress recognized that *excessive* speculation – not de minimis or moderate speculation – could create a burden on interstate commerce if it caused unreasonable or unwarranted price changes. As shown above, the Commission's proposal would not address the risk of excessive speculation with which Congress was concerned, but would ban a long hedger with hedge positions up to the speculative position limit from holding even one net long speculative position. The Commission nowhere explains how a hedger's establishment of speculative positions well under (or even up to) the speculative limit would amount to 'excessive' speculation.") *See* FIA Letter at 21-23.

physical energy transaction or an OTC energy swap and then an equal and opposite futures transaction.

- First, actively-traded futures contracts do not exist for every type of commodity or for every specification of the same type of commodity. For example, Morgan Stanley frequently transacts in the NYMEX No. 2 Heating Oil futures contract to hedge its exposure in inventories and physically settled and financially settled contracts for different grades of jet fuel, kerosene and diesel fuel, as well as different grades of heating oil. Thus, futures positions act as hedges for commodities that are not perfectly matched by specification.

- Second, actively-traded futures contracts do not exist for every location at which commercial companies purchase, sell, and deliver energy commodities. For example, the primary hedging instruments for natural gas in the U.S. are the NYMEX Henry Hub natural gas futures contract and the significant price discovery contract traded on the IntercontinentalExchange ("ICE"). There are, however, over 90 natural gas pipelines in the U.S., each with multiple delivery points; and of those, approximately 60 delivery points are actively traded. In addition, transactions at many more delivery points located along these pipelines may be hedged with the Henry Hub contracts traded on NYMEX or ICE. However, these hedges have basis risk based upon the difference between the price at the physical delivery point on the pipeline and the price at the futures contract delivery point. Morgan Stanley and other integrated financial and energy services companies help their clients manage this basis risk. Thus, futures positions act as hedges for transactions that are not perfectly matched by delivery location.

- Finally, actively-traded futures contracts may not exist or match the dates or tenors of the hedging and trading needs of Morgan Stanley's clients. Morgan Stanley may provide a client with a long-dated swap with a term of several years. Because futures contracts may not exist for the entire tenor of the swap or because liquidity in deferred months may not be sufficient, Morgan Stanley may hedge its exposure under the swap by entering into a risk offsetting position using a sequence of near-term futures contracts that are rolled forward through the term of the swap agreement. Thus, futures positions act as hedges for transactions that are not perfectly matched by tenor.

As the foregoing examples show, Morgan Stanley and other integrated financial and energy services companies that provide risk management products and services rely on futures contracts as part of a complex portfolio to hedge inventories and transactions that are not

perfectly aligned with the specification, delivery point or tenor of futures contracts.[6] Thus, it is not practical for companies that provide customized risk management contracts to "earmark" each futures contract as a hedge for any given transaction. A particular futures position may serve to offset the risk characteristics of different transactions that are held in the same portfolio. To the extent transactions being hedged are swaps and other financially-settled derivatives, the "crowding out" provisions would not allow the company to hold a speculative position. The company, therefore, may be exposed to the legal risk that a futures position executed as a hedge may be re-characterized as a speculative position if it is no longer treated as the hedge to the original, single transaction. This legal risk would have the serious consequences of endangering the company's ability to retain its hedge exemption and/or risk management exemption and exposing it to the corresponding enforcement risk. The likely result of this legal risk will be to further discourage participation in the futures markets, which will disrupt the energy markets and the availability of cost-efficient risk management products and services.

Many market participants turn to intermediaries like Morgan Stanley to assume their basis risk in energy transactions because Morgan Stanley has the experience, available financial and human capital, large transaction portfolio, and global physical operations to effectively manage the risk. Entities, like Morgan Stanley, only are able to take on this role because their active presence in the energy markets gives them the information necessary to make informed decisions about whether and when to assume these risks. As a result, they need the flexibility to manage their positions based upon the composition of their entire portfolio and in response to changing market conditions. The proposed prohibition against holding a speculative position within a hedge or risk management exemption will eliminate this flexibility and hinder companies, like Morgan Stanley, from providing clients with risk management products and services that address their unique needs. Without the ability of intermediaries to perform this important role, producers, merchants and end-users alike would either need to bear more risk or invest a significant amount of time, human resources, technology and capital to manage these complex basis risks on their own.

B. By Restricting Hedge and Risk Management Exemptions, The Proposed Rule Will Limit The Ability Of The Market To Resolve Distressed Market Situations In A Timely And Orderly Manner

Many important, time-sensitive transactions will be difficult, if not impossible, to execute under the Proposed Rule. The inability of Morgan Stanley, and other similar companies to execute these types of transactions efficiently will increase, rather than reduce, systemic risk in the energy futures and related markets.

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[6] Besides specification, delivery point and tenor, there are other characteristics by which hedging activity is not perfectly matched against positions and contracts being hedged. Different modes of transportation (*e.g.*, by pipeline, cargo or barge) and storage costs may pose an impact on pricing that differs from futures contract specifications used for hedging purposes. Similarly, "ratio hedging" may be used where there is volumetric difference arising from unequal behavior of different commodities. For example, due to the different chemical attributes of fuel oil and crude oil, one might typically hedge a swap referencing a notional volume of fuel oil with positions equal to 80% of the corresponding volume of NYMEX light, sweet crude oil futures contracts. Other characteristics affecting pricing include liquidity and credit considerations.

In 2009, for example, Morgan Stanley, in coordination with the NYMEX and ICE, agreed to acquire a large, complex energy position of NYMEX options and ICE futures contracts from an FCM that had assumed the position from a customer with financial problems. At the time, price volatility was high and market liquidity was low, and as a result, it was very difficult to value the position. Under the existing regulatory framework, and relying upon its risk management experience, Morgan Stanley was able to take over the position and the related risk in a timely and efficient manner. After assuming the open positions, Morgan Stanley managed them within its existing portfolio and proceeded to liquidate some positions over time, while keeping others open to serve as hedges of existing transactions and anticipated new transactions. By doing so, Morgan Stanley enabled the FCM, the NYMEX, and the market as a whole to avoid significant disruption that would have ensued if the FCM had to conduct an immediate forced liquidation of the open positions.

Under the Proposed Rule, it is highly unlikely that Morgan Stanley could have assumed the risk of the FCM's positions because, as a commercial hedger and swap dealer, Morgan Stanley could not certify to the Commission that every position it assumed from the FCM on day-one would constitute a hedge or risk management position. If the Commission implements the Proposed Rule, it necessarily will limit, if not eliminate, the ability of exchanges, their members, and integrated companies like Morgan Stanley rapidly to assume the positions of companies experiencing financial difficulties, particularly when markets are under stress. The many practical problems and unintended adverse consequences that the Proposed Rule would create counsel against moving forward with the Commission's proposal.[7]

C. The Proposed Rule Will Force Many Market Participants To Choose Between Conducting A Physical Energy Business or Acting As A Swap Dealer

Rather than allowing a swap dealer to hedge its entire risk management position, the Proposed Rule imposes an arbitrary cap of two times the AMC or single month speculative position limits. In addition, it prohibits commercial hedgers from using their exemptions to hold risk management positions if the hedge position exceeds the two times speculative limit cap. There is no legal or policy basis for this distinction because the risk management positions serve precisely the same function as commercial or bona fide hedges. The Commission's Proposed Rule arbitrarily crowds out the ability of an integrated entity to hedge its legitimate swap business risks.

The Proposed Rule requires integrated financial and energy services companies to make a Hobson's choice: if they need to rely on the uncapped bona fide hedge exemption, they cannot hedge any of the risk from their swap dealer business if their commercial hedge position is more than two times the speculative position limit. For an integrated company, this restriction will mean choosing between providing its clients with risk management products and services that

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[7] It is not sufficient for the Commission to say that in distressed situations it will grant waivers or will otherwise facilitate transactions. Often, prompt action is required to prevent a potential default from affecting the broader market. Market participants will be discouraged by the likely delays that may ensue after requesting waivers from government officials before they can consummate transactions in distressed situations. By the time participants receive a waiver in a form upon which they reasonably can rely, a large default likely will already have occurred and its consequences already will have begun to ripple through the financial or energy sectors.

include physically settled products and OTC derivatives or limiting its presence in the physical energy markets in order to provide more OTC swaps to its clients. Ultimately, many similarly-situated market participants may be forced to exit some, or all, of their commodity or risk management businesses or hedge all of their risk management transactions in the OTC derivatives market. Alternatively, they may elect to hedge in non-U.S.-based futures markets which will greatly increase their basis risk. Neither consequence will diminish, eliminate or prevent excessive speculation. Either result, however, will force longstanding liquidity providers from the U.S. energy futures market to the detriment of the price discovery and hedging functions of those markets.

D. Under The Proposed Rule, Integrated Companies Will Be Constrained In Their Ability To Provide Important Products And Services On An Efficient Basis

In an effort to help the Commission understand the actual consequences that the Proposed Rule will have on commercial energy market participants, Morgan Stanley discusses below several examples of the types of physical supply and risk management services that it and other integrated companies currently provide to their clients, but that they may no longer be able to provide in a cost-efficient manner under the Proposed Rule. These examples are illustrative and by no means exclusive.

1. *Supplying Heating Oil Throughout The Northeastern United States*

Morgan Stanley is one of a number of companies that supply wholesale distributors with heating oil on the U.S. East Coast. Additionally, Morgan Stanley sublets its leased storage capacity to the U.S. Government to enable it to maintain a strategic heating oil reserve in the U.S. Northeast. As part of its heating oil business, Morgan Stanley buys and sells heating oil in amounts that meet the demand of its wholesale customers. Traditionally, the industry builds heating oil inventories in the summer and fall so that adequate supplies are available to meet peak winter demand. Morgan Stanley acquires heating oil through a diversified, global network of petroleum producers and refiners. Its ability to avail itself of this global network has proven beneficial to heating oil consumers in the Northeast, who have received reliable supplies even during times of market stress.[8]

Morgan Stanley efficiently manages its heating oil distribution business by hedging the price risk it incurs in connection with these positions through a combination of OTC swap contracts and NYMEX heating oil futures contracts. As discussed in the following example involving jet fuel, the Proposed Rule may limit the ability of Morgan Stanley to provide this important service to wholesale distributors, and ultimately to heating oil consumers in the Northeast.

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[8] For example, in 2005 when hurricanes Katrina and Rita disrupted heating oil production at refineries along the U.S. Gulf Coast and the shipment of heating oil to the Northeast on the Colonial Pipeline, Morgan Stanley diverted to the Northeast numerous shipments of heating oil cargos originally to be shipped from the Mediterranean to Asia.

2. *Hedging An Airline's Exposure To Jet Fuel Price Volatility*

A domestic airline that has entered into a series of long-term contracts to purchase jet fuel at regional index prices for delivery at multiple locations may want to enter into a long-term hedge to protect itself against future price increases. Because no jet fuel futures contract exists, the airline may elect to enter into one or more swaps with a swap dealer in which it sells a notional quantity of jet fuel for a fixed price to offset a corresponding quantity of physical jet fuel that it has agreed to purchase at floating prices tied to a regional price index. Under the other "leg" of the swap, the airline pays the regional index price to the swap dealer. Based on the swap with the airline, the swap dealer is exposed to the risk that the floating price it receives from the airline will decline. Accordingly, the swap dealer will enter into a transaction that increases in value if the regional price declines. The swap dealer normally would hedge its fixed price risk on the purchase of the swap by selling NYMEX heating oil futures.

If its existing heating oil hedge exemption position exceeds two times the speculative position limit, the swap dealer's ability to enter into a risk management position has been crowded out by its hedge position. Thus, under the Proposed Rule, the swap dealer's only options are to: (1) decline to enter into the swap with the airline (possibly leaving the airline with no risk management alternative); (2) elect to hedge the swap with another OTC swap (assuming that the other swap counterparty can somehow hedge its price risk); (3) enter into the swap without a corresponding hedge (assuming the position complies with its internal policies relating to the extent of permissible unhedged OTC derivatives positions); or (4) reduce its hedge position to make room for a risk management position (which would leave some other commercial risk unhedged). None of these options prevents excessive speculation in the energy futures markets – the purported goal of the Proposed Rule. Instead, the Proposed Rule would limit legitimate commercial hedging activity that benefits users of energy commodities.

Morgan Stanley provides airlines with risk management services involving swaps and other financially settled products similar to the example above. Additionally, Morgan Stanley provides risk management services in the form of physically settled transactions to numerous airlines that, as major consumers of jet fuel, are naturally exposed to cash market price risk and volatility. For example, during the past several years, Morgan Stanley has relied upon its credit rating and extensive energy markets experience to provide a U.S.-based domestic airline with a uniquely cost-effective way to reduce its overall risk while conserving limited capital. Through a long-term physical supply agreement, Morgan Stanley agreed to provide each of the airline's approximately 35 domestic airport locations with a steady supply of jet fuel at competitive rates. Under the terms of the agreement, Morgan Stanley owns and manages the price risk of the jet fuel stored in the airline's oil storage terminals located at the airports. Thus, the airline retains the benefit of its terminal and pipeline infrastructure, but without the risks and capital constraints associated with operating an extensive fuel supply operation.

Under the Proposed Rule, Morgan Stanley may be constrained in its ability to provide this solution to airlines or other market participants because it may be impossible to hedge the risks associated with these transactions without reducing or divesting other aspects of its hedging business. The Proposed Rule may allow Morgan Stanley a hedge exemption for heating oil futures contracts associated with the physical jet fuel positions in this example, as well as a heating oil-related risk management exemption of up to 20,200 contracts AMC and 13,600

contracts for the Single Month limit, but not higher. The position limits and exemptions in the Proposed Rule may be insufficient to permit Morgan Stanley to use futures contracts to hedge both the price risks it incurs by taking physical jet fuel and heating oil positions and the price risks it incurs in its risk management business. Morgan Stanley's ability to provide airlines with flexible and cost-efficient financially and physically settled risk management products such as those described above may be severely affected if its hedging needs for jet fuel plus its unrelated heating oil supply hedges, described above, together take its AMC and Single Month positions over the proposed two-times risk management cap.[9]

3. Providing Power Plant Financing

Morgan Stanley's investment banking and project finance groups are called upon often to arrange a finance facility for a client that is planning to either build or acquire a natural gas fired power plant. In order to demonstrate its ability to repay the loan, the prospective plant owner must demonstrate control over commodity costs — specifically, the price it pays for natural gas and the revenues received from the power that will be generated. Morgan Stanley's Commodities desk can provide a solution by, structuring and executing the following arrangement: Morgan Stanley sells to the plant long-term, fixed-price physical natural gas and, in exchange, buys fixed-price physical power at an agreed-upon conversion rate. This transaction locks in the spread between the price of natural gas used by the power plant and the sales price of power produced by the plant, which creates the fixed cash flow needed to support the power plant company's debt obligation. Morgan Stanley faces risk on the fixed-price sale of natural gas and on the fixed-price purchase of power. In order to manage these price risks, Morgan Stanley may hedge its long-term power purchase and long-term natural gas sale as follows. First, it may sell fixed-price power to a wholesale reseller of power or a municipal utility to offset its purchase of the long-term power. Second, it may buy NYMEX Henry Hub natural gas futures contracts to hedge the sale of natural gas to the power plant company. If natural gas prices should subsequently fall, the loss Morgan Stanley incurs on the obligation to provide fixed price natural gas to the power plant will be offset by the increase in value of its short futures position.

Typically, these are long-term deals, and in the case of natural gas, the requisite number of futures contracts in the hedge described above would be approximately equivalent to the total amount of natural gas that a large power plant will consume over a five- or ten-year period. Depending upon the liquidity of the NYMEX natural gas market throughout the five or ten year forward curve, Morgan Stanley might choose to hedge its risk using futures contract months that may not be perfectly aligned with its monthly natural gas delivery obligations over the term of the sale to the power plant company. Essentially, Morgan Stanley is assuming the basis risk that results from the difference in time between the natural gas deliveries to the power plant and the natural gas futures contract months of its hedge. Morgan Stanley also is assuming the

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[9] The Commission estimated that approximately ten traders could be affected by the proposed limits. However, the Commission staff determined that for the smaller volume heating oil and gasoline contracts during the period January 1, 2008 through December 31, 2009, 35 unique positions owners would have been affected by the AMC and 16 position owners would have been affected in any one day. *See* Slide 7 of the Division of Market Oversight presentation at the Commission Open Meeting on Proposed Energy Speculative Position Limits Rule (January 14, 2010).

geographic basis risk of the difference between natural gas prices delivered at Henry Hub and delivered at the power plant's location.

Morgan Stanley assumes and manages these tenor and geographic basis risks, as well as other basis risks, as part of its overall portfolio of trades. However, in order to do this, Morgan Stanley's natural gas futures position would be very large and, when combined with other bona fide and risk management hedge positions, it may exceed the two-times speculative position limit cap of the Proposed Rule. If Morgan Stanley cannot qualify for a large enough hedge exemption to accommodate this position, its ability to provide such risk management transactions, critical to the financing of necessary future generation capacity, may be limited. As a result, Morgan Stanley may be constrained by the Proposed Rule from offering this service to its customers, thereby limiting the number of companies capable of providing risk management, and reducing competition in this sector and, consequently, the efficient use of capital by power plant owners.

The Commission should consider the unintended consequence to energy markets of reducing the risk management role of integrated financial and energy services companies by imposing the proposed restriction on commercial and risk management hedge exemptions. Reduced participation by creditworthy providers of important risk management contracts and services will reduce energy market liquidity and, thereby, widen the bid/ask spread and increase costs for end-users and, ultimately, consumers.

Finally, another potential unintended consequence of the Proposed Rule is the negative impact on initiatives to promote investments in energy independence and renewable energy resources. For example, an affiliate of a commercial energy company that also has a swap desk may not be able to invest in renewable energy projects because it cannot secure long-term financing without a cost-effective way to hedge its price risk.[10] If the most experienced and flexible market participants are crowded out of the energy futures markets, renewable energy developers and other entities that rely on customized risk management products will have nowhere to turn. As a result, potential investors may be discouraged from investing in energy projects with long-term price risk, such as wind farms, power plants, and transmission infrastructure.

E. Uncertainty About The Size Of Future Position Limits Will Discourage Long-Term Investment In The U.S. Energy Sector

The uncertainty of having position limits adjusted every year based on the open interest formula will further disrupt the ability of market participants to hedge their business risk. As demonstrated by the examples above, Morgan Stanley, like other similar companies, makes long-term contractual commitments to clients that it hedges for years into the future. These long-term positions potentially will have to be reduced in order to comply with new position limits resulting from a change in open interest, even though the hedging requirements will not have

[10] The Proposed Rule is inconsistent with the Obama Administration's goal of increasing the amount of energy generated from renewable resources because it would have the effect of limiting the ability of companies to make investments in renewable energy resources.

changed.[11] Moreover, in an effort to comply with the limits and exemptions, market participants voluntarily may choose to trade at levels intentionally below their permitted limits to ensure that they do not inadvertently breach those limits. The unintended consequence of the Proposed Rule may be that the cumulative effect of the position reduction by energy market participants over time and the self-imposed lower limits will create a domino effect of further reducing open interest, which, in turn, will cause the Commission to further reduce position limits year after year.

F. Futures Positions That Offset The Risks Of Financially Settled Transactions Of Swap Dealers With Their Counterparties Constitute Legitimate Hedges

Section 4a(c) requires that the CFTC define a bona fide hedge "consistent with the purposes of the [CEA]."[12] In 1987, the Commission recognized that risk management positions should qualify for exemptions to exchange-imposed position limits: "The Commission notes that providing risk management exemptions to commercial entities . . . is similar to a provision in the Commission's hedging definition, *viz.*, the risks to be hedged arise in the management and conduct of a commercial enterprise."[13]

The Commission originally defined a bona fide hedge in 1977 when it adopted Regulations 1.3(z) and 1.47.[14] Although the Commission has not modified the definition to accommodate new forms of risk management transactions and positions, its interpretation of what constitutes a bona fide hedge has evolved with the markets and the risk management needs of market participants to include the hedging transactions of swap dealers. As the FIA notes in its comments, the Commission correctly has concluded that swap dealers incur price and other risks in the conduct of a commercial enterprise. Accordingly, the Commission routinely has granted bona fide hedge exemptions from the Commission's speculative position limits to swap dealers seeking to manage price risk.[15]

Morgan Stanley and other market participants reasonably relied on the Commission's interpretations of its Regulations and the CEA when building their energy commodity and OTC

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[11] Section 151.3(b) of the Proposed Rule allows for an exemption to the position limits for positions that are open "prior to the effective date of any rule, regulation, or order that specifies a limit." *See* 75 F.R. 4169. However, the Proposed Rule does not state whether this exemption will apply to the yearly readjustment of position limits.

[12] The CEA states that bona fide hedging transactions or positions "may be defined to permit producers, purchasers, sellers, middlemen, and users of a commodity or a product derived therefrom to hedge their legitimate business needs." CEA Section 4a(c).

[13] 52 Fed. Reg. 34637.

[14] 75 Fed. Reg. 4150.

[15] In 1986, the House Agriculture Committee thought the definition needed to be expanded to allow hedge exemptions for financial firms using the futures markets to manage risks. *See* Testimony of General Counsel Dan M. Berkovitz, CFTC (July 28, 2009), citing H. Rept. 624, 99th Cong., 2d. Sess., at 45-7 (1986). In 1987, the CFTC clarified its interpretation of the definition to explain that it did not apply only to mitigation of risks in the cash market. *See* 52 Fed. Reg. 27196 (July 20, 1987).

derivatives businesses. It would not be reasonable now to exclude the legitimate commercial risk of swap dealers from the definition of bona fide hedges.[16]

G. The Proposed Position Aggregation Provision Will Further Exacerbate The Constraints Of The Proposed Rule

The Proposed Rule will impose a requirement to aggregate positions based on a 10 percent ownership interest — irrespective of the actual control over trading — rather than the standard based upon ownership and control over trading currently set forth in Regulations 150.4(d) and 150.3(a)(4) for Federal speculative position limits in futures contracts on the agricultural commodities set forth in Regulation 150.2 and which is replicated in exchange-set speculative position limits. The Commission's proposal to require aggregation of the positions of all entities that share a 10 percent or greater common ownership (regardless of control) is unnecessarily onerous and ignores independent management that exists between and among corporations that have common, minority ownership, as is the case with many of Morgan Stanley's subsidiaries and affiliates.[17] For example, funds in Morgan Stanley's investment management business may from time to time hold futures positions that may have to be aggregated with Morgan Stanley's energy commodities positions, even though the businesses are separately managed and the trading separately controlled. The proposed change in the aggregation requirement for energy positions will restrict independently managed entities from hedging risks and constrain financial and energy companies, such as Morgan Stanley from using the futures markets to conduct physical energy commodities business and provide cost-efficient risk management services for clients.

Section 4a(a) of the CEA does not reference ownership by itself as a criterion for aggregation of positions. Rather, it refers to the positions "directly or indirectly controlled" by persons or trading done by "two or more persons acting pursuant to an expressed or implied agreement or understanding."[18] Thus, the Commission's proposal is not a fair and reasonable interpretation of the ownership criterion. Many times in the past the Commission staff has confirmed that a passive investment in another entity does not require the acquiring entity to aggregate the futures positions that may be held by the other entity, absent any indicia of control over the other entity's futures trading activities. Morgan Stanley and others have built businesses and made long-term investments in the energy sector on the basis of this longstanding view.

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[16] *See, e.g.*, *International Union United*, v. NLRB, 802 F.2d 969 (7th Cir. 1986), *citing Vehicle Mfrs. Ass'n v. State Farm Mutual Automobile Ins. Co.*, 463 U.S. 29, 57 (1983) (holding that an agency must examine the relevant data and articulate a satisfactory explanation for its decision to change an existing regulatory requirement).

[17] As a matter of corporate law, 10 percent ownership in a company does not give a firm the ability to direct another company's futures trading. Moreover, absent control, 10 percent ownership does not make a company an affiliate of the owner. Other agencies may use a 10 percent ownership interest as a proxy for control; however, these are typically applied in circumstances that have little in common with an entity attempting to control the futures trading of its affiliate. For example, the FERC defines an "affiliate" as "[a]ny person that directly or indirectly owns, controls, or holds with the power to vote, 10 percent or more of the outstanding voting securities of the specified company," 18 C.F.R. § 35.36(a)(9)(i), or more generally, as "[a]ny person that is under common control with the specified company." 18 C.F.R. § 35.36(a)(9)(iv). These definitions are based on the concept of common control, but in the context of FERC's historically rate-regulated markets.

[18] 7 U.S.C. § 6a(a).

To comply with the Commission's proposed aggregation requirement, entities that operate separately and completely independently from one another would, paradoxically, have to put in place systems and controls that will combine their trading positions when, but for the mechanical aggregation requirement, they would not even have knowledge of one another's trading. Development and implementation of these systems will be costly and time consuming and do nothing to prevent excessive speculation.

In some cases, it may not be appropriate for two separately managed business lines of the same diversified company to share information regarding their respective positions. For example, consistent with its fiduciary duties, the investment management businesses of a financial services company may limit the flow of its information that may be passed to affiliates. There may even be situations in which two competitors with a joint venture relationship suddenly find themselves in the predicament of having to aggregate and share information about each other's positions. The structure of modern corporations can be extremely complex. In a situation of a broad financial services company with interests in many businesses that may need to use the futures markets to hedge their activities, there may be contractual and fiduciary conflicts created by the need to allocate the limited hedging capacity that may be available as a result of application of the proposed limits. As the FIA pointed out in its comments on the Proposed Rule, the Commission has not offered any substantive reason for putting market participants through this expense and trading upheaval or for disregarding historic Commission and staff precedent and policy. Therefore, Morgan Stanley respectfully requests that the Commission reconsider its aggregation proposal and adopt instead the control-based standard set forth in Regulation 150.5(g).

IV. The Proposed Rule Is Not Necessary To Prevent Excessive Speculation[19]

A. The Proposed Rule Is Focused On Market Concentration And Not Excessive Speculation

Despite the Proposed Rule's stated goal of diminishing or eliminating excessive speculation, it appears instead to be designed to diminish or eliminate alleged market concentration.[20] The Commission's focus on concentration, rather than excessive speculation, will have the anticompetitive effect of reducing the number of integrated financial and energy services companies available to provide the complex risk management products and services needed by producers, processors, merchants and users of energy commodities. Smaller entities are not likely to be able to provide the same type of risk management contracts and services as integrated financial and energy companies because of the expertise and amount of capital required. For these same reasons, the Proposed Rule would deter or discourage others from

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[19] It is further noted that in their comment letters, FIA, ISDA, and others have stated that the CEA does not authorize the Commission to issue the Proposed Rule without first making a finding that the Rule is necessary. *See* FIA Comments at 15-17; ISDA Comments at 3-4.

[20] Indeed, as noted by Commissioner Scott O'Malia, although the Proposed Rule "makes a case for the statutory justification for the CFTC to impose position limits under Section 4a(a) of the Act . . . the proposal fails to make a compelling argument that the proposed position limits, which only target large concentrated positions, would dampen price distortions or curb excessive speculation." 75 Fed. Reg. 4172. *See also* FIA Comments at 17-19; ISDA Comments at 2-3.

entering these markets. As a result, the Proposed Rule will limit the number of competitors available to provide important risk management contracts to participants in the U.S. energy markets.[21]

B. The Proposed Rule Is Not Necessary Because The Commission's Existing Position Reporting Requirements, Market Surveillance Structure And Enforcement Authority Are Sufficient To Prevent Excessive Speculation

The NOPR does not suggest that the Commission's existing market surveillance and enforcement authority is insufficient to protect the energy futures market from the adverse consequences of excessive speculation. The CFTC's existing surveillance structure is extensive, especially when coupled with exchange-set and monitored accountability levels. Moreover, the CFTC's Division of Enforcement supplements the Commission's reporting and surveillance programs by diligently enforcing the requirements of the CEA and the Commission's Regulations.

The CFTC's Large Trader Reporting requirements and Special Call provisions enable the Commission to identify the market composition of positions and are the core of the market surveillance program. To complement the Commission's reporting and surveillance programs, the futures exchanges also have their own large trader reporting requirements, which they use to conduct CFTC-required market surveillance. If the CFTC detects market congestion that potentially may be due to excessive speculation, the Commission can direct the exchanges to take action or use the Commission's emergency and/or injunctive authority to impose mandatory trading and/or position limits. In addition, Section 150.5 of the Commission's Regulations requires all futures exchanges to adopt and enforce speculative position limits. For energy contracts, the Commission has permitted the NYMEX to set speculative position limits in the spot month, while relying on position accountability levels for AMC and single month positions.[22] Last year, the Commission also required ICE Futures Europe to impose position reporting, speculative limits, and position accountability levels on its NYMEX-linked energy futures contracts. These requirements have significantly enhanced the Commission's ability to detect and prevent excessive speculation in energy contracts.

Morgan Stanley respectfully submits that the combination of CFTC and exchange market surveillance, spot-month position limits, and accountability levels has been effective in preventing excessive speculation in the energy markets. In fact, based upon the information cited in the NOPR, the Commission's staff has concluded, both independently and as part of an interagency task force specifically formed to study developments in commodities markets, that there is no evidence that speculative trading in energy futures had any impact on energy market

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[21] The CFTC is required to take the effect on competition into account when designing rules. *See* CEA Section 15(b), 7 U.S.C. § 19 (2010) (the CEA directs the Commission to consider antitrust policy and to "endeavor to take the least anti-competitive means of achieving the objectives of this Act, as well as the policies and purposes of this Act, in issuing any order or adopting any Commission rule or regulation").

[22] The Commission relies on its Rule Enforcement Review program to monitor the exchanges' market surveillance programs to ensure that the exchanges are effectively enforcing their self-regulatory obligations.

prices.[23] On the contrary, all of the available evidence shows that recent market prices reflected supply and demand fundamentals.[24] Accordingly, no further regulation is warranted or necessary.

Because the Commission has concluded that, notwithstanding the success of the current reporting and surveillance regime, additional protections are prudent, Morgan Stanley recommends that the Commission enhance its current use of its existing Special Call authority by increasing the frequency of its current special call on swap dealers and commodity index traders from a monthly to weekly basis. Morgan Stanley believes that, since instituting the monthly call, the Commission has received valuable information and gained an increased understanding of the scope and involvement of different market participants in the OTC derivatives markets that reference not only the energy futures contracts that are the subject of the Proposed Rule but numerous other commodity futures contracts. An increase in the frequency of the reports from a monthly to weekly basis is warranted as it would provide for a more meaningful degree of transparency to the Commission of trends and developments to assist it in its critical mission of surveillance of the futures markets. The Commission also might consider imposing targeted reporting requirements that would provide more information with respect to the energy commodity markets, as long as the CFTC continues to maintain the confidentiality of traders' proprietary information.

In addition to increasing the frequency of the Special Calls from a monthly to a weekly basis and other enhanced reporting requirements, Morgan Stanley supports the FIA's recommendation to establish federal accountability levels that aggregate economically equivalent positions across markets.[25] These accountability levels would be a reasonable way for the Commission to achieve its stated goals, while preserving the flexibility that companies like Morgan Stanley need to conduct their business. The FIA proposal would allow the CFTC to identify potentially destabilizing positions across markets. The CFTC could then use its existing authority to request information from market participants through its Special Call provision and to take other appropriate remedial action when necessary. In contrast to the Proposed Rule, the FIA proposal would not have a disruptive effect on the energy markets because it would not require market participants to reduce or abandon any important businesses or product lines.

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[23] *See* Interim Report on Crude Oil (July 2008); Staff Report on Cotton Futures and Options Market Activity During the Week of March 3, 2008 (January 4, 2010); the Report on Large Short Trader Activity in the Silver Futures Market (May 2008); the Interim Report on Crude Oil (July 2008). In addition, CFTC economists writing independently have published articles analyzing the effect of speculation in the energy markets. *See, e.g.*, Price Dynamics, Price Discovery and Large Futures Trader Interactions in the Energy Complex, April 28, 2005; Fundamentals, Trader Activity and Derivatives Pricing (December 4, 2008) *See also* Testimony of the Chief Economist and Director of Market Surveillance Before the Subcommittee on General Farm Commodities and Risk Management, Committee on Agriculture, U.S. House of Representatives (May 15, 2008).

[24] As the Commission acknowledged in the NOPR, Congressional and Commission hearings have not produced a consensus among participants that excessive speculation caused commodity price volatility in recent years. *See* 75 Fed. Reg. 4148.

[25] *See* FIA Comments at 29.

V. The Commission Should Not Promulgate The Proposed Rule Until Pending Legislation Is Finalized

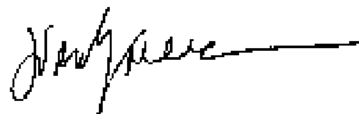
Congress is currently debating legislation that amends the same sections of the CEA that the Commission relies upon in support of the Proposed Rule and that, if passed, will override the Proposed Rule. Morgan Stanley respectfully requests, therefore, that the Commission defer acting on the Proposed Rule at least until it has the benefit of Congress' legislative guidance on this issue.

Morgan Stanley supports any investment that results in a more robust and economically sound market for futures and derivatives products. However, the costs associated with promulgating a rule that may be obsolete on day one are substantial and should not be ignored absent a clearly articulated, compelling need for immediate action. Any new regulation that imposes requirements as far-reaching and complex as this Proposed Rule will require market participants to expend considerable time and money designing and deploying new technology infrastructure and compliance procedures. If Congress amends the CEA in a manner that changes the requirements of the Proposed Rule, the Commission and market participants will have wasted valuable time and resources. The Commission can avoid such an inefficient result by not acting until after Congress concludes its deliberations.

VI. Conclusion

Morgan Stanley commends the Commission on its initiatives to review developments in the energy and other commodity markets and to seek public comment regarding the issues discussed in the Proposed Rule. However, for the reasons explained herein, Morgan Stanley respectfully urges that the Commission not adopt the Proposed Rule. We welcome the opportunity to discuss these issues further with the Commission and its Staff.

Respectfully submitted,



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