**From:** Krupka, Catherine <Catherine.Krupka@sutherland.com>
**Sent:** Monday, April 26, 2010 3:26 PM
**To:** secretary <secretary@CFTC.gov>
**Cc:** Sherrod, Stephen <SSherrod@CFTC.gov>; Van Wagner, David <dvanwagner@CFTC.gov>; Heitman, Donald H. <dheitman@CFTC.gov>; Fekrat, Bruce <bfekrat@cftc.gov>
**Subject:** Comment File 10-002: FIEG Comments on Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulation
**Attach:** FIEG Position Limit Comments.pdf

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All:

Please find attached the comments of the Financial Institutions Energy Group on Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulation.

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April 26, 2010

Via Electronic Mail: Secretary@CFTC.gov

David Stawick, Secretary
U.S. Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

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

Dear Mr. Stawick,

On January 26, 2010, the Commission in its Federal Register notice, 75 Fed. Reg. 4144 (the "Proposal"), invited public comment in the above-referenced rulemaking. The Financial Institutions Energy Group ("FIEG") herein submits comments for consideration by the Commission.

For the reasons stated below, FIEG urges the Commission not to adopt the Proposal. In addition to being ill-timed due to impending legislation, factually unsupported in the record, and inconsistent with the Commodity Exchange Act ("CEA"), FIEG believes the Proposal, if adopted, would reduce participation in U.S. futures markets and ultimately hurt consumers. Speculation is an important working component of futures markets. Without the liquidity created by speculators, hedging would become more expensive as there is an inverse correlation between market liquidity and bid-offer spreads. Thus, if the Commission adopts the Proposal, FIEG is concerned that current U.S. futures market participants, both hedgers and speculators, will migrate to offshore futures or less transparent over-the-counter markets.

FIEG also notes that thousands of nearly-identical comments filed in this rulemaking by individuals have been generated electronically through other commenters' web sites.[1] To ensure that substantive comments are not lost in a sea of nearly-identical form-letter comments, FIEG respectfully requests that its comments and others'

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[1] For example, see the comment generator on the Petroleum Marketers Association of America ("PMAA") web site at http://pmaa.www.capwiz.com/pmaa/issues/alert/?alertid=14925776 that helps individuals file comments endorsing the PMAA's April 9, 2010, comments. While this type of form-letter generator does not appear to violate the Commission's public comment rules, 17 C.F.R. § 13.4 (2009), or instructions in the Proposal, the filing of thousands of repetitive comments may obscure the substantive comments of other individuals, companies and industry associations when coupled with the Commission's practice of bundling filed comments for posting on its web site. Those attempting to review the Commission record may find it difficult to locate substantive comments in a file also containing hundreds or thousands of repetitive form-letter comments. Even the PMAA's April 9, 2010, substantive comments are located within a group of 194 form-letter comments that have been bundled together on the Commission's comment file web page.

substantive comments be posted separately from form-letter comments on the Commission's comment file web page.

**Background**

FIEG is comprised of investment and commercial banks that provide a broad range of financial services to all segments of the U.S. and global economy. Its Members and their affiliates act as marketers, lenders, underwriters of debt and equity securities, and proprietary investors. FIEG Members are active participants in various organized commodity and commodity derivatives markets.

**Comments**

FIEG agrees with several other commenters that the Proposal is premature given ongoing legislative action and that the Commission has not met its burdens of demonstrating factual and legal bases in support of the Proposal.

**The Proposal is Ill-Timed**

As noted in the filed comments of the Futures Industry Association ("FIA Comments"), Congress is actively considering legislation amending the Commission's position limit authority.[2] The Commission cites CEA section 4a(a) as a legal basis for the Proposal. On December 11, 2009, the U.S. House of Representatives passed a financial regulation bill that includes derivatives regulation reform provisions. Since then, two derivatives reform proposals have been introduced in the U.S. Senate. The House bill and each of the Senate proposals would modify the Commission's statutory authority to set position limits under CEA section 4a(a). The Senate Majority leadership has set a procedural vote to begin debate on a derivatives reform bill by Monday, April 26, 2010,[3] the same day comments on the Proposal are due. If the Proposal is adopted and derivatives reform legislation is enacted shortly thereafter, the Commission likely would have to amend the Proposal to the extent it conflicts with the legislation, increasing costs for the Commission and market participants alike. As there is no urgent need for the Proposal, the Commission should indefinitely postpone consideration of the Proposal until Congress has acted on the derivatives reform proposals.

**The Proposal is Not Supported Factually**

Section 4a(a) of the CEA requires the Commission to explain why it thinks the Proposal is necessary to diminish, eliminate or prevent sudden or unreasonable fluctuations or unwarranted changes in commodity prices resulting from excessive speculation. The Commission has not complied with this requirement. As noted by the FIA, without notice of the factual basis for the Proposal, the public cannot comment on

[2] FIA Comments at 13, available at http://www.cftc.gov/LawRegulation/PublicComments/10-002.html.

[3] *See Senators Close to Deal on Financial Regulation*, New York Times, Apr. 25, 2010, available at http://www.nytimes.com/reuters/2010/04/25/business/business-us-usa-financial-senate.html?src=busln.

the Commission's justification for it.[4] Thus, FIEG urges the Commission to either withdraw this rulemaking entirely or suspend it to make the required showing.

**The Proposal Does Not Comply with the CEA**

As discussed in the FIA Comments, the Commission has proposed a "crowding out" rule that counts a hedger's bona fide hedging positions against the speculative position limit where that hedger holds at least one speculative position.[5] This "crowding out" rule violates section 4a(c) of the CEA, which states, "No rule, regulation, or order issued under subsection (a) of this section shall apply to transactions or positions which are shown to be bona fide hedging transactions or positions … ." Therefore, FIEG believes that the "crowding out" restriction in the Proposal must be abandoned.

## Responses to Commission Questions

In addition to its comments, see Attachment A for FIEG's responses to some of the Commission's questions from the Proposal.

## Conclusion

FIEG respectfully urges the Commission to abandon the Proposal because it is ill-timed, factually unsupported, and inconsistent with the CEA. FIEG also agrees with the FIA that the costs of the Proposal are high and its benefits, if any, are uncertain[6] and that the proposal would be arbitrary and capricious if adopted in its current form.[7] FIEG appreciates the Commission's consideration of its comments.

Sincerely

/s/ Catherine M. Krupka

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[4] FIA Comments at 14.

[5] FIA Comments at 5, 21-23.

[6] FIA Comments at 28-29.

[7] FIA Comments at 29-30

Attachment A: FIEG Responses to Questions
April 26, 2010

*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?*

The Commission's proposed limits on West Texas Intermediate crude oil, natural gas, heating oil, and gasoline futures and options contracts (the "referenced energy contracts") are not necessary to diminish, eliminate or prevent any burdens on interstate commerce that may result from position concentrations.

The burdens on interstate commerce specifically referenced in the CEA are sudden or unreasonable fluctuations or unwarranted changes in the price of a commodity (hereinafter "SUFUCIPs"). Assuming, *arguendo*, that the energy commodity price movements in 2008 were SUFUCIPs, the Commission has not shown that the proposed limits would have in any way diminished, eliminated, or prevented their occurrence. By way of comparison, the agricultural commodities that were already subject to speculative limits imposed by the Commission experienced similar price movements in 2008. If Commission-imposed limits previously were not effective in diminishing, eliminating or preventing alleged SUFUCIPs in agricultural products, then the logic for their use to accomplish that goal in energy products is undermined.

The CEA authorizes the Commission to address only "excessive speculation" that leads to SUFUCIPs, not speculation generally, position concentrations, or even excessive speculation that results in reasonable and warranted price changes.[1] The Commission has yet to demonstrate that large position concentrations can lead or materially contribute to SUFUCIPs.[2]

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

To state that a method *should* be utilized to diminish, eliminate, or prevent the burdens of SUFUCIPs caused by excessive speculation, presumes that SUFUCIPs and excessive speculation have occurred, that the Commission or someone has identified them, or at a minimum distinguished them from reasonable market activity and

[1] If numerous market participants anticipate a dislocation of physical supply, even excessive speculation may result in reasonable and warranted price fluctuations, and any limits inhibiting such activity are beyond the scope of CEA section 4a(a).

[2] In fact, an argument can be made that speculation, if anything, tends to moderate excessive price swings. Presumably, a speculator chooses to buy or sell a commodity because he or she believes that the current price does not accurately reflect the fundamentals of supply and demand, and will soon change in the speculated direction. Thus, when a speculator takes a long position (buys), it is because he or she believes the current price is below the "correct" value, and that the price will soon rise. Conversely, when a speculator takes a short position (sells), presumably it is because he or she believes the price is excessive and will soon revert to the mean by going down. Therefore, when prices are "overheated," speculators are likely to contribute to "reigning in" the excess, because they can be expected, on average, to bet on the price to soon decline. These actions will tend to contribute to price modulation, not price amplification.

resulting price movements. It is exceedingly difficult to propose a remedy for the burdens of SUFUCIPs without defining, describing, or even questioning what makes certain fluctuations or changes in price sudden, unreasonable, or unwarranted. It is essential that excessive speculation resulting in SUFUCIPs be described and distinguished from beneficial market activity. Thus, it is unclear what additional regulation beyond the existing exchange accountability level regime is needed to address these undefined threats.

Even if the Commission had defined what constitutes excessive speculation or SUFUCIPs, as opposed to reasonable speculation or price changes, the Commission should consider existing or less invasive measures (than position limits) that may be less disruptive to the futures and spot energy markets than the proposed limits.

*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?*

Because the proposed position limits do not address any actual problems in the relevant energy contract markets, there likely will be no improvement in the liquidity, market efficiency or price discovery capabilities in these markets. In fact, the proposed limits have the potential to reduce liquidity, market efficiency, and price discovery capabilities in the relevant energy contract markets and in the related market for risk management services. Clearly, liquidity will be reduced because several market participants will be required to reduce their positions on the futures markets to comply with the new limits.

With respect to the markets for the referenced energy contracts, the demand for the contracts is comprised of participants willing to buy the referenced energy contracts while supply is comprised of participants willing to sell the referenced energy contracts.[3] A graph of supply and demand would meet at a point represented by the equilibrium price, P, and equilibrium quantity, Q.[4] Because the proposed limits would reduce the ability of both longs and shorts to participate in the futures markets, reducing the amount either are able to buy or sell, respectively, at each unit price, we can imagine

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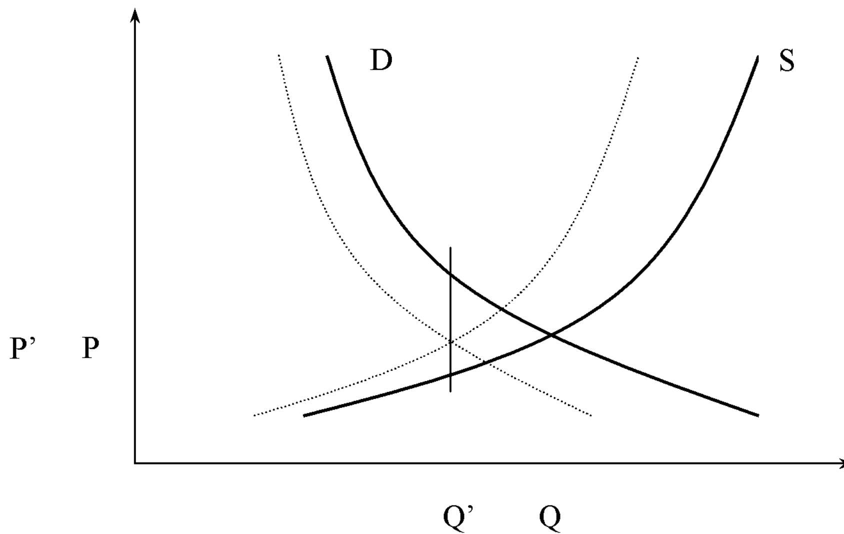
[3] A hypothetical all-months market for each of the four classes of referenced energy contracts would be comprised of the open interest for a year in all of the related instruments listed in the Commission's proposed rule for each class of commodity. The fungibility of the futures and options contracts within a class may be established by the Commission's limits proposal covering all the related instruments within a class, with due regard for conversion factors and delta-adjustments. Inclusion of near and distant months within a year follows the Commission's convention for the proposed limits. For ease of discussion, the markets in the referenced energy contracts are discussed generally, though it is not intended to imply that there is fungibility across commodity classes.

[4] While the quantity, Q, likely would be a year's total open interest in each class of referenced energy contract, the price, P, perhaps would be the average commodity price for the year's open interest within a class. Though a more rigorous study of these markets is beyond the scope of these comments, these markets are sufficiently defined to discuss them in the context of the Commission's proposed limits.

the demand and supply curves both would be shifted to the left. Assuming both curves shifted more or less equally, the new equilibrium price, P', would be similar to the original equilibrium price P. However, it is clear that the movement of both demand and supply curves to the left would result in a decrease in quantity to Q'. Thus, the effect of the proposed limits on price would be negligible, but there would be a reduction in open interest. Note that even with no change in prices, there would be a dead weight loss of consumer welfare, similar to that caused by the actions of a monopolist or taxation by a regulator, denoted by the triangular shape running from the original equilibrium point (P, Q) to intersections of the reduced quantity, Q', with the original supply and demand curves.[5] See Figure 1, below.

*Figure 1*

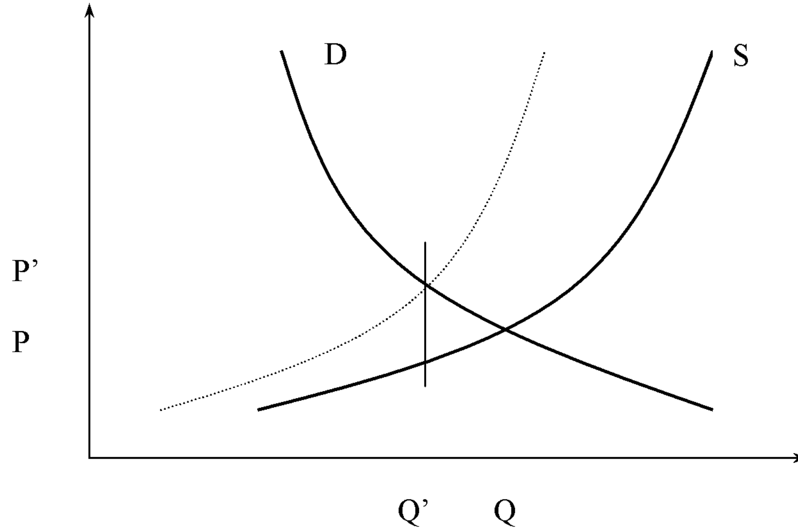



The provision of risk management services depends on the availability of various OTC derivatives that are hedged using the referenced energy contracts. A reduction in open interest in the referenced energy contract markets resulting from the imposition of position limits likely would result in an overall decrease in the supply of related risk management services. If we imagine the supply and demand curves for risk management services in the relevant commodities meeting at a point represented by equilibrium price, P, and equilibrium quantity, Q, the imposition of position limits would shift the supply curve to the left, resulting in a higher price, P', and a lower

[5] A corollary to this argument is that by removing all position limits on agricultural commodities, it is likely that there would be no appreciable effect on prices even though the level of futures open interest would increase. This increase in open interest would have the effect of increasing overall consumer welfare.

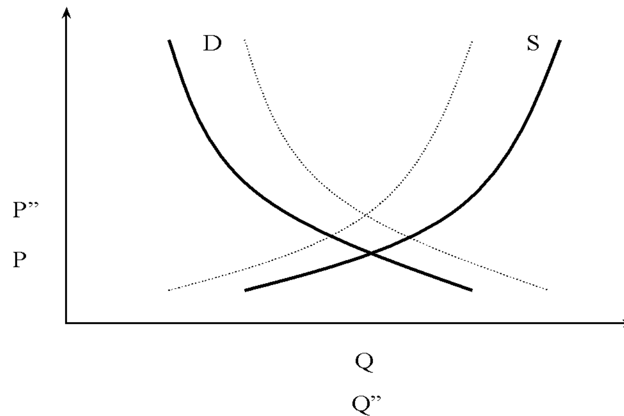
quantity, Q'. Again, a dead weight loss can be denoted on the graph in Figure 2.[6] Thus, the Commission's proposed limits likely would reduce open interest and increase costs to entities that require risk management services.

*Figure 2*




[6] It may be assumed that demand for risk management services would not be greatly affected by the imposition of position limits as commercial enterprises and other hedgers would continue to desire risk management services. However, as a result of the imposition of position limits in the referenced energy contracts, it is possible that market participants formerly using futures for risk management purposes may be forced to resort to OTC swaps and options instead. This would have the effect of increasing the demand for risk management services, moving the risk management demand curve to the right and resulting in a new equilibrium price, P", and quantity, Q". *See* Figure 3.

*Figure 3*




Note that while this new equilibrium quantity, Q", may or may not be close to the original equilibrium quantity, Q, it is certain that the resulting new equilibrium price, P", will be higher than the original equilibrium price, P.

Additionally, price discovery likely would also be inhibited by the proposed limits as market participants that are currently active in both the futures and underlying physical markets will be inhibited from engaging in the arbitrage between futures and spot prices, the front month and second to the front month, or between similar contracts on different exchanges. The reduction in this type of arbitrage may harm price convergence between futures and spot prices and between futures contracts whose prices normally converge.

Beyond the effects on liquidity, market efficiency, and price discovery noted above, the proposed speculative position limits likely would negatively affect commodity producers, users, processors, and merchant handlers (collectively "commercial entities") and lead to higher prices for consumers; the opposite of what is intended. Commercial entities look to risk management services providers to enable long-term hedging while freeing up balance sheet capital, for instance, via lien-based ISDA swaps. Large and sophisticated risk managers have the capability and the risk appetite to provide these services, which in turn allow commercial entities to invest more of their capital in research, development, or inputs. Smaller risk managers may not have the infrastructure, balance sheet, or the risk appetite to provide long-term services of this nature. As commercial entities are left with less capital to invest in technology or production, ultimately consumers will face fewer choices and higher prices.

*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.*

As discussed above, any position limits will only serve to reduce consumer welfare and/or raise the prices of futures, risk management services, and commodities. However, to the extent the Commission is able to show that position limits are necessary to diminish, eliminate or prevent the burdens on interstate commerce that may result from excessive speculation, FIEG would not support any position limits less than ten percent of the total open interest of the instruments that aggregate into any one of the referenced energy contracts.

Based on the Herfindahl-Hirschman Index measure of market concentration used by the United States' primary competition regulators, the U.S. Department of Justice ("DOJ") and U.S. Federal Trade Commission ("FTC"), a ten percent position limit likely would be consistent with the existence of a competitive market. Under the DOJ/FTC HHI methodology, the sum of the squares of all market participants' shares of a defined market are compared to the following benchmarks: an HHI under 1000 is viewed as competitive and not susceptible to exercises of market power or collusion; an HHI between 1000 and 1800 is viewed as moderately concentrated and somewhat susceptible to exercises of market power or collusion; and an HHI above 1800 is viewed as highly concentrated and susceptible to exercises of market power or collusion.[7]

A ten-percent market share position limit would be sufficient to promote a competitive market as it corresponds to no fewer than ten market participants and a maximum HHI value of 1000, which under the DOJ/FTC guidelines constitutes an unconcentrated and competitive market. In fact, under the HHI methodology it is even possible for a market participant to have a market share of 30 percent without exceeding the 1000 HHI threshold.[8] Thus, even if the Commission were to set a ten percent position limit for the referenced energy contracts, it should allow for exemptions up to 30 percent under appropriate circumstances.

[7] Transactions that increase the HHI by more than 100 points in concentrated markets presumptively raise antitrust concerns under the Horizontal Merger Guidelines issued by the DOJ and FTC. See the description available on the DOJ's Internet web site at http://www.justice.gov/atr/public/testimony/hhi.htm.

[8] This would occur if all other market participants had shares of one percent or less.