BETTER MARKETS
TRANSPARENCY · ACCOUNTABILITY · OVERSIGHT

December 2, 2010

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

Re: Position Reports for Physical Commodity Swaps (CFTC RIN 3038-AD17)

Dear Mr. Stawick:

Better Markets, Inc.[1] appreciates the opportunity to comment on the above-captioned proposed rules (the "Proposed Rules") of the Commodity Futures Trading Commission ("CFTC") The purpose of the Proposed Rules is to establish data reporting requirements needed to implement the provisions of the Dodd-Frank Financial Services Reform Act (the "Dodd-Frank Act") that require the establishment of position limits for certain physical swaps, including aggregate position limits, as appropriate, for swaps that are economically equivalent to certain Designated Contract Market contracts.[2]

Introduction

The CFTC is to be congratulated for the insightful and timely proposal of rules needed for implementation of the position limits requirements of the Dodd-Frank Act in the timeframe which has been mandated. The Proposed Rules provide for reporting of extraordinarily useful operational data. This reporting regime can be effectively scaled up as additional data flows become available from swap data repositories and other sources. The use of a narrower set of data than will be available in the future to support limitations on positions is a reasonable way to begin the process of monitoring and regulating comprehensive positions of market participants. The data will cover a large portion of the market. Position

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1 Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

2 Notice of Proposed Rulemaking, 17 CFR Parts 15 and 20.

limits will be valuable and will add to market transparency even though some data will be missed initially.

The use of futures equivalence, as set forth in Appendix 20 A of the Proposed Rules, is an excellent approach to making market data more useful. This will add dramatically and substantially to market transparency.

As pointed out by the CFTC, the reporting of paired swaps and swaptions will have a number of benefits for the marketplace, beyond the implementation of position limits. The data will be assembled based on price relationships that reflect the ways that the markets view transactions. It will remedy much of the asymmetry of information (and resulting market power of certain financial institutions) that have plagued the marketplace and continue to do so. An information set which is practically meaningful to market participants and regulators alike will become available, providing needed structure to market data. The price relationships among paired swaps and swaptions will allow price transparency in a format that enhances the usefulness of the large amounts of non-aggregated trade data which will be available under the Dodd-Frank Act.

Our comments on the Proposed Rules are limited to a few points:

- The approach used in the second numbered paragraph of the definition of "paired swap or paired swaption" in the Proposed Rules is too narrow. We propose an alternative which relies on market practices and parallel practices of clearing organizations and historic price correlations, to supplement the product and delivery point standards in the Proposed Rules.
- Reportable position sizes should be reduced to 25 contracts.
- Clearing organizations should report the delta-adjusted values of paired contracts, as well as the gross values and deltas.
- The transaction data should specify the capacity in which the reporting entity entered into the transaction. Reporting entities should specify their membership in a controlled group and their status as an agent or fund or commodity pool manager where applicable.

The Notice of Proposed Rulemaking also asks for comments regarding the potential for delaying the consideration of proposed rules on position limits until 60 days after final rules on the definition of "swap dealer." We emphatically believe that such a delay would be counter to the policy and requirements of the Dodd-Frank Act and would not be in the public's interest. The Commissioners have made their intent regarding the meaning of "swap dealer" clear in the proposed rule on this definition and in public pronouncements concerning that proposed rule. Anxiety of a limited number of market participants regarding the scope of "swap dealer" must not be allowed to delay the broader benefits of position limit rules. Surely, any entity that requires some accommodation in compliance schedules can be dealt with individually.

Proposed Rules

The core concept in the Proposed Rules is the definition of "paired swap or paired swaption." This definition establishes the principles under which swaps and swaptions will be aggregated into price-related groups for reporting in support of position limits which are to be established in a subsequent rulemaking.

Paragraph 2 of this definition provides as follows:

> (2) Directly or indirectly linked, including being partially or fully settled on, or priced at a differential to, the price of the same commodity for delivery at the same location, *or locations with substantially the same supply and demand fundamentals*, as that of a commodity futures contract listed in § 20.2. [Emphasis Added.][3]

In the discussion of the italicized language, the CFTC makes the following observation:

> Under paragraph two, a paired swap would include swaps that are based on the same commodity as that of a 20.2 listed futures contract but deliverable at locations that are different than a 20.2 listed futures contract's delivery locations, so long as such locations have substantially the same supply and demand fundamentals as that of a 20.2 listed futures contract reference delivery location.[4]

This undoubtedly encompasses some of the contracts which should be captured in the definition, but not all.

The Proposed Rules address the price relationships between paired swaptions (represented by delta adjustments) as follows:

- Clearing organizations are to provide the gross long and short-paired swaption positions on a non-delta adjusted basis. (Section 20.3).
- Clearing organizations are also required to report daily deltas for every unique swaption put and call, expiration date and strike price (Section 20.3).
- Reporting entities are required to report long and short-paired swaption positions on both a non-delta adjusted and a delta adjusted basis. (Section 20.4) If the positions are uncleared, the deltas must be reasonable and analytically supported.

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[3] Proposed Rules, Section 20.1.
[4] Notice of Proposed Rulemaking, pages 67260-67261.

Discussion

Contracts with Different Delivery Points or Other Differences. The quoted paragraph of the definition of "paired swaps and swaptions" should accomplish one primary purpose: it should cover contracts for physical commodities having different delivery points or differing in other ways, but having prices that are sufficiently related that they should be grouped for purposes of position reporting.

Often, this sort of price relationship occurs because the different delivery points are subject to substantially the same supply and demand fundamentals. However, this is not always the case. The essential feature of the relationship is not the supply and demand fundamentals of the different delivery points, but rather the enduring price relationship between the two contracts. This link may rest on other factors than different delivery points with shared fundamentals. For example, it may arise between different grades of a commodity, or different secondary products of a single commodity, rather than between different delivery points for precisely the same commodity.

Therefore, by focusing the definition on the supply and demand relationships of the delivery points rather than the price relationships themselves, the Proposed Rule offers an unnecessarily narrow definition of a paired swap or swaption. This may be the cause of price relationships, but not in all cases. We propose that the focus be shifted to the actual issue - market price relationships. Location issues should be considered along with other factors, but in a second level of analysis, which involves examining the cause behind the relationship to validate the price relationships which are apparent from the market.

The markets for crude oil and derivatives such as jet fuel are good examples. Physical characteristics like storability, storage capacity and relative absence of distribution constraints can make the physical delivery points much less meaningful. Crude oil delivered in many different and remote locations is closely related in terms of price. The same is true of jet fuel. In contrast, products like electricity which are not easily stored and have severe limits on distribution capacity are less broadly correlated.

As a result, in the market, crude oil has a widely applicable reference price - WTI. In contrast, power contracts have few and very narrowly applicable reference prices, such as PJM West Hub.

Another consideration is the concept of the "same commodity." Just as supply and demand similarities can cause two contracts to have related prices, so can the processing of one product that is the subject of a contract into another which is the subject of a second contract. For instance, crude oil grades have a strong price relationship with the crude oil reference price, regardless of delivery points. These grades are often hedged with WTI contracts, the widely used reference price. Even though they do not constitute precisely the same product, they are sufficiently closely related that these grades should be considered as valid pairs with WTI contracts. A position in Brent or Dubai Sour should

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therefore, for reporting purposes, be paired with a position in WTI as a position in crude oil outright. Similarly, a position limit on crude oil should apply across all variants of crude. It should not be possible to artificially widen position limits by claiming that a position in Brent is distinct from a position in WTI, so that the two should not be aggregated. Different grades of crude are all, in an important and relevant sense, the "same commodity."

Returning to the jet fuel example, under common trading practices, it is widely accepted that there is a close relationship between heating oil, jet fuel and other middle distillates. Delivery locations are not significant to the correlations between jet fuel contracts because of the specific market structure, storage capacities and distribution capabilities. Rather than arising from fixed differentials between delivery points, the significant price relationships here are based on commonly understood relationships between various refined products. Traders recognize strong hedging relationships among jet fuel, heating oil and other middle distillates like diesel, based on the similarity of the products and enduring price correlations between them. They often use these contracts interchangeably, with minimal reference to location of delivery. This suggests strongly that the concept of the "same commodity" must be given a broad interpretation.

The concept of the "same commodity" must therefore be made broader to cover relationships beyond that of different delivery points with shared supply and demand fundamentals. The definition should reflect the market's understanding of what constitutes the "same commodity," which extends to different grades, and other variations that trade at a stable and well-defined differential, are commonly regarded as hedge equivalents, and display enduring and widely recognized price relationships.

We propose a layered approach to this definition, as follows:

1. A persuasive indication of strong price relationships is the behavior of the market, since participants have a financial stake in the existence of the relationship. The analysis should consider the hedging relationships that are broadly used by market participants in hedging activities. If a listed contract is used as a hedge for a non-listed contract, for instance, this is a strong indication that the price relationships of the two contracts are sufficient to support pairing.

2. The practices of clearing organizations are also indicative. They provide netting of initial margin through credits for price-correlated contracts. This is an indication of potential pairs. It should be noted, however, that the basic purpose of clearing organizations is credit management. As a result, the contracts qualifying for netting of initial margin constitute a narrower list than paired contracts that are appropriate for position calculations.

3. The existence of an enduring price relationship should qualify two positions to be considered paired, provided it is justified by the other considerations. Thus, although gold and silver may display an enduring price relationship, they clearly should not be considered as the same commodity for reporting purposes, because

they are not treated as such by the market. However, jet fuel and heating oil, which would not be paired under the Proposed Rules as they stand, should be paired because of (a) their enduring price relationship, and (b) the fact that they are generally used as equivalent hedges by market participants, and also pass the other tests listed below. Historic price correlations between the potentially paired contract and the listed contract can, in the proper circumstances, be predictive of future relationships. It is most useful in cases where hedging activity is difficult to determine. Market participant behavior as described in paragraph 1, is a more reliable factor. The strength of the correlation should indicate merely that the relationship is significant.

4. Finally, the physical characteristics of the subject of the swaps or swaptions which might be paired based on the foregoing criteria should serve as a check on potential pairings. Where the cause for a relationship can be determined, it reinforces the conclusion drawn from the other factors. These physical characteristics may indicate that market practices, treatment by clearing organizations and historic correlations do, or do not, support reporting as paired swaps and swaptions. Examples of the physical characteristics should include:

    a. Distribution systems and delivery locations in relation to supply and demand relationships. Where the supply and demand relationships are similar, the pairing of price-related contracts is supported.

    b. Relationships between grades of the same basic products, such as grades of crude oil. Where the specific products are grades of the same basic product, the pairing is supported.

    c. Relationships between the products based on common sources for processing, such as heating oil, diesel and jet fuel. Where the specific products are produced by different processing of the same underlying product, the pairing is supported.

Reportable Position Size. The CFTC states that "reportable paired swaps position would include 50 or more paired swaps positions in a futures equivalent month...."[5] The CFTC further notes that "this threshold is higher than the minimum 25 contract reporting levels in effect for futures positions under regulation 15.03. Previously, the Commission had determined that the reporting levels in regulation 15.03 would not affect small entities...."[6]

We recommend that the regulation 15.03 standard of 25 contracts be applied for purposes of the Proposed Rule reporting threshold. The 25-contract threshold has not proven burdensome and consistency is served by its use. *Especially considering that the aggregate*

[5] Notice of Proposed Rulemaking, page 67264.
[6] Notice of Proposed Rulemaking, pages 67264-67265.

of all contracts paired with the listed contract will determine position size, a lower threshold for reporting is needed.

Pre-reporting Netting of Long and Short Positions. We note that the clearing organizations provide gross swaption positions and deltas, but not the net positions, under the Proposed Rules. The CFTC should require that the calculated net positions be submitted, as well as the gross positions.

For netting of long and short paired swap positions, the clearing organizations maintain algorithms which project price relationships based on historic price movements and a variety of other factors (including duration, price levels, volatility, seasonality and others). One element is the net value of the paired contracts. This information could serve a purpose relative to swaps which is similar to the purpose of delta factors as they relate to swaptions. It can be used to calculate cleared and uncleared positions held by reporting entities. The CFTC should require submission of this information in netted form.

Reporting of Status Information. Section 20.4 of the Proposed Regulations deals with reporting entities and Section 20.5 addresses Series S filings. In order to integrate the Proposed Rules with future rules on position limits, it is important that the status of the filing entity be made clear. The filing should include information regarding whether the transactions were entered into as an agent, fund manager, manager of a commodity pool or otherwise acting on behalf of other entities, specifying the entity represented. The filing should also indicate whether the reporting entity is part of a controlled group which may include other reporting entities, specifying the controlled group and the related reporting entities.

It should be noted that reporting the status of the filing entity parallels the approach of CFTC Form 40 Statement of Reporting Trader, both in terms of detail terminology. This form includes categories such as "commodity pool operator," "commodity trading advisor," and others. Establishing the capacity in which the filing entity executes the reported transactions will be significant information as positions are calculated. While it is understood that Form 40 is to be amended in the future, its general approach can be a basis for reporting especially regarding capacity.

Conclusion

We propose that the second numbered paragraph of Proposed Rule Section 20.1, definition of "paired swap or paired swaption" be amended to include the criteria of (1) market hedging practices and (2) initial margin netting offered by clearing organizations and (3) historic price correlation. Physical market characteristics which are the underlying causes of price relationships should be treated primarily as a confirmation of conclusions drawn by application of these new criteria. The existing criterion, supply and demand dynamics of separate delivery points, is one of these characteristics. Two others are based on the relationships between the products. These relationships include physical processing of a common underlying product (e.g., jet fuel, heating oil and diesel) and specific variations in grade or quality of the underlying products (weight, viscosity and sulfur content of crude oil. This approach would be a better reflection of market practices and would give priority to the central focus of the definition.

We further propose that the reporting threshold for a given contract be reduced to 25 contracts.

We propose that clearing organizations provide ***netted*** swaption position information as well as ***gross*** position information and ***deltas***. Further, we propose that clearing organizations provide the results of price relationship algorithms used to net paired swap positions for initial margin purposes, the results can then be used to calculate positions on data provided by reporting entities and clearing organizations collectively.

Finally, we propose that reporting entities be required to specify membership in a controlled group and their status as agent, fund or commodity pool manager or other capacity in relation to execution of reported contracts.

We emphatically recommend that the implementation of a proposed rule 20 relating to position limits should not be delayed until 60 days following the adoption of final rules defining "swap dealer."

We hope that our comments are helpful in your consideration of the provisions of this Proposed Rule.

Sincerely,

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