March 28, 2011

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

RE: RIN Nos. 3038-AD15 and 3038-AD16—Comments on Proposed Rulemaking Regarding Position Limits for Derivatives, 76 Fed. Reg. 4752 (Jan. 26, 2011)

The National Corn Growers Association ("NCGA") and the Natural Gas Supply Association ("NGSA") submit the following comments in response to the Notice of Proposed Rulemaking, Position Limits for Derivatives, 76 Fed. Reg. 4752 (Jan. 26, 2011) (the "NPRM") recently issued by the U.S. Commodity Futures Trading Commission (the "Commission"). References made herein to the Commodity Exchange Act (the "CEA") refer to that statute as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act" or the "Act").

Correspondence regarding this submission should be directed to --

Sam Willett
Senior Director of Public Policy
National Corn Growers Association, Washington DC Office
122 C Street NW, Suite 510
Washington, DC, 20001-2109
(202) 628-7001
Email: willett@dc.ncga.com

And

Jennifer Fordham
Vice President, Markets
Natural Gas Supply Association
1620 Eye Street, NW
Suite 700
Washington, DC 20006
Direct: 202-326-9317
Email: jfordham@ngsa.org

Founded in 1957, NCGA is the largest trade organization in the United States, representing 35,000 dues-paying corn farmers nationwide and the interests of more than 300,000 growers who contribute through corn checkoff programs in their states. NCGA and its 48 affiliated state associations and checkoff organizations work together to create and increase opportunities for their members and their industry.

Established in 1965, NGSA represents integrated and independent companies that produce and market approximately 40 percent of the natural gas consumed in the United States. NGSA encourages the use of natural gas within a balanced national energy policy and promotes the benefits of competitive markets to ensure reliable and efficient transportation and delivery of natural gas and to increase the supply of natural gas to U.S. customers.

Because of the potential for the Dodd-Frank Act to unnecessarily limit the hedging tools available to corn producers and to impede what is and has been a healthy, competitive, and resilient natural gas market, NCGA and NGSA played an active role in the shaping of the Act during its passage and wish to continue this role in ensuring the Act's successful implementation.

I. Overview of Necessary Changes to the Proposed Rule

The position limits proposed in the NPRM for certain physical commodity derivative contracts go beyond what is "necessary" and "appropriate" under section 4a of the CEA as amended by the Dodd-Frank Act and would unnecessarily limit trading, thereby threatening to harm liquidity and price discovery in derivatives markets contrary to Congress's intent. In addition, the proposed rule does not provide adequate flexibility for portfolio-based hedging and imposes unreasonable reporting requirements on market participants making use of the bona fide hedging exemption, thus threatening to limit end users' abilities to cost-effectively hedge their risk. The position limits established by the Commission, and the reporting and other requirements associated with them, must preserve end users' abilities to manage risk while protecting physical commodity derivatives markets from harm as Congress intended. For these reasons, NCGA and NGSA respectfully submit comments regarding the following necessary changes to the proposed rule to make it consistent with the requirements of the Act:

(1) The position limits should focus primarily on physical delivery contracts in the spot month only.

(2) The Commission must properly account for all sources of supply when imposing spot-month position limits based on deliverability.

(3) The Commission must provide adequate flexibility for portfolio-based hedging in its definition of bona fide hedging and should reduce the reporting burden associated with the hedging exemption from a daily requirement to a monthly requirement.

II. The Position Limits Should Focus Primarily on Physical Delivery Contracts in the Spot Month Only.

To be consistent with the CEA's requirements and the Commission's own well-established policies, the new position limits should focus on (1) facilitating orderly settlement of contracts and convergence between physical and financial markets and (2) preventing market

manipulation, *e.g.*, corners and squeezes, between physical and financial markets. This would be best accomplished by limiting the position limits in the final rule to physical delivery contracts in the spot month only. Such contracts have far greater potential for the kind of market manipulation, distortion, and settlement problems (and accompanying unreasonable fluctuations and unwarranted changes in price) the rule was intended to address than do any cash-settled contracts or contracts outside of the spot month.

The Commission should eliminate its proposed position limits on these other classes of contracts—or should increase them substantially from the levels proposed—to avoid unnecessarily limiting liquidity and price discovery in such contracts, which would harm the abilities of end users to hedge risk and to make well-informed long-term business decisions. Moreover, freeing up these markets in this way would have the beneficial effect of incenting end users with large hedge positions, who otherwise might hold onto physically-delivered spot month positions as allowed under the bona fide hedge exemption, to move their positions to cash-settled contracts and/or contracts outside of the spot month (simply to avoid some of the burdens of reporting requirements associated with using hedge exemptions). This would bolster the rule's effect in facilitating orderly settlement and convergence of physically-delivered spot month contracts.

A. The Position Limits on Cash-Settled Contracts in the Spot Month Should Be Eliminated, or Be Increased Substantially and Be Based on Open Interest.

Based on the requirements of the Act and the Commission's well-established policies, the proposed position limits on cash-settled contracts in the spot month should be eliminated from the final rule, or should be increased substantially and be based on open interest in the referenced contracts, as opposed to deliverable supply in the commodity. Under the Dodd-Frank Act, the position limits established by the Commission must be limited to what is "necessary" and "appropriate" to address "[e]xcessive speculation . . . causing sudden or unreasonable fluctuations or unwarranted changes in prices" and to "prevent market manipulation, squeezes, or corners."[1] Along these lines, the Commission has established policies in its regulation of designated contract markets ("DCMs") that recognize that the threat of manipulation, distortion, and excessive speculation is primarily in physical delivery contracts in the spot month.

For example, Core Principle 5 in the Commission's DCM regulations requires DCMs to adopt position limits, where "necessary and appropriate," to "reduce the potential threat of market manipulation or congestion, *especially during trading in the delivery month*."[2] At the same time, Core Principle 5(b)(2) provides that:

> In general, position limits are not necessary for markets where the threat of excessive speculation or manipulation is nonexistent or very low. *Thus, contract markets do not need to adopt speculative position limits for . . . contracts specifying cash settlement where the potential for distortion of such price is negligible.*[3]

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[1] *See* CEA §§ 4a(a)(1), 4a(a)(3)(B).
[2] *See* 17 C.F.R. Pt. 38 App. B (emphasis added).
[3] *Id.*

Accordingly, the Commission's practice in evaluating DCMs' compliance with Core Principle 5 has been to ensure that the *spot-month limit on physically-delivered contracts* does not exceed 25 percent of estimated deliverable supplies. By contrast, for *spot-month limits on cash-settled contracts*, the Commission has employed a more flexible evaluation based on the nature of the underlying market.[4]

Cash-settled contracts in the spot month may not have the potential for unwarranted changes in price and market manipulation that physical delivery contracts have because they do not require delivery of a physical commodity that is subject to limited supply. As such, the prices of cash-settled spot-month contracts can float freely and converge easily to the price of the physical commodity as settlement approaches. By contrast, it is theoretically possible that limitations on transportation and on available supply of an underlying physical commodity can lead to price distortions and opportunities for price manipulation in spot month contracts that must be satisfied by physical delivery. (Actual examples of this may be rare, but proper market regulation should acknowledge the possibility. For example, one might observe such distortion if a trader "corners" the market by gaining a controlling share of the physical commodity and then artificially withholds such supply from "short" traders required to deliver the commodity under physical delivery contracts.[5]) For these reasons, as the Commission's own Core Principles recognize, position limits should primarily target physical delivery contracts in the spot month.

Indeed, in order to avoid unnecessarily limiting trading, the Commission should consider eliminating position limits on cash-settled spot month contracts altogether in its final rule. At the very least, because the cash-settled market is decoupled from the physical market as describe above, any position limits on cash-settled spot month contracts should be based on open interest in the referenced contract, not deliverable supply. Further, since the Commission has determined that 25% of deliverable supply is an appropriate level for position limits on physically-delivered spot month contracts (effectively, 25% of the ultimately available supply for such contracts), 25% of open interest should be considered an appropriate level for position limits on cash-settled contracts (again, 25% of the ultimately available supply with respect to such contracts), if both limits are to gauge the relative potential for market distorting effects and market manipulation.

B. The Position Limits on Both Cash-Settled and Physically-Delivered Contracts Outside of the Spot-Month Should Be Eliminated, or Be Increased Substantially.

Again based on the requirements of the Act and the Commission's well-established policies, the proposed position limits on both cash-settled and physically-delivered contracts outside of the spot month should be eliminated from the final position limits rule, or should be increased substantially. The Act provides that any position limits established must be limited to

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[4] *See* NPRM at 4758.

[5] The Commission can address its concern about a trader's possible incentive to exert market power in the physical commodity to manipulate the price to advantage his or her position in cash-settled derivative contracts by continuing to make the position limit on cash-settled spot month contracts conditioned on not holding cash or forward positions in the spot month in an amount greater than one-quarter of the deliverable supply. *See* section § 151.4(a)(2)(iii) of the proposed rule.

what is "necessary" and "appropriate" to address "[e]xcessive speculation . . . causing sudden or unreasonable fluctuations or unwarranted changes in prices" and to "prevent market manipulation, squeezes, or corners." As described above, these threats of manipulation, distortion, and excessive speculation are primarily of concern in physically-delivered spot month contracts only. Neither physically-delivered nor cash-settled contracts outside of the spot month have the kind of settlement-related convergence issues that make physically-delivered spot-month contracts susceptible to price disruption and manipulation. Accordingly, the Commission's Core Principles for DCMs currently provide that "[m]arkets may elect not to provide all-months-combined and non-spot month limits."[6]

The Commission's proposed position limits on contracts outside the spot month threaten to unnecessarily and inappropriately limit trading, contrary to the Act's requirements and Congress's intent. Sections 4a(a)(3)(B)(iii)-(iv) of the CEA provide that any position limits set by the Commission must "ensure sufficient market liquidity for bona fide hedgers" and "ensure that the price discovery function of the underlying market is not disrupted." However, if position limits are unnecessarily imposed on derivative contracts or are set too low, trading will be artificially limited, to the detriment of market liquidity and price discovery in such contracts.

For these reasons, the Commission should consider eliminating its proposed position limits on non-spot month contracts altogether. If not eliminated, the limits should be established at 25% of open interest in the referenced contract. As proposed, the rule would establish limits at 10% of open interest for the first 25,000 contracts and approach a mere 2.5% as open interest expands beyond that. However, since the Commission has proposed that 25% of deliverable supply is an appropriate level for the position limits on physically-delivered spot month contracts, 25% of open interest should be considered an appropriate limit on cash-settled contracts, if both limits are to address the relative potential for distortion and manipulation within a market.

C. The Commission Should Increase the Initial Position Limit on Spot Month Natural Gas Contracts and Clarify the Meaning of "Physical Delivery Contracts."

The proposed initial position limit on spot month natural gas contracts in Appendix A of the proposed rule should be increased substantially to avoid unnecessarily limiting trading, liquidity, price discovery, and end users' abilities to effectively hedge with such contracts. The current limit appears to allow market participants to maintain a position of only 1,000 physically-delivered and 1,000 cash-settled contracts in the spot month.[7] Under existing exchange limits, which are based on the same principles the Commission must follow in establishing the new position limits under the Dodd-Frank Act, market participants can hold positions of 1,000 Henry Hub natural gas futures contracts in the NYMEX futures market, 1,000 such CME swap contracts, and 1,000 such ICE swap contracts. The Commission should increase its initial position limits on natural gas contracts to at least allow market participants to hold positions equivalent to these levels, which has provided adequate protection to the market thus far. In

[6] *See* 17 C.F.R. Pt. 38 App. B Core Principle 5(b)(4).

[7] The Commission should clarify in Appendix A itself that the position limits in the table in Appendix A apply separately to physically delivered and cash-settled positions, pursuant to section 151.4(a) of the proposed rule.

addition, the Commission should clarify that the proposed position limits do not apply in any way to forward contracts and that the use of the term "physical delivery contracts" in the rule does not imply otherwise, as required by Congress's exclusion of forward contracts from the definition of the term "swap" under section 1a(47)(B)(ii) of the CEA.

III. The Commission Must Measure "Deliverable Supply" Broadly Enough if Such Measure is Used to Determine Position Limits on Natural Gas Contracts.

Where "deliverable supply" is used to determine position limits, the Commission must ensure that it measures deliverable supply broadly enough to avoid unnecessarily and inappropriately limiting trading.[8] The Commission has specifically invited comment regarding "how broadly or narrowly [it should] consider what constitutes deliverable supply."[9] The NPRM defines "deliverable supply" as:

> In general, . . . the quantity of the commodity meeting a derivative contract's delivery specifications that can reasonably be expected to be readily available to short traders and saleable by long traders at its market value in normal cash marketing channels at the derivative contract's delivery points during the specified delivery period, barring abnormal movement in interstate commerce.[10]

More specifically, the NPRM provides that:

> [Estimates of deliverable supply] would include supplies that are available through standard marketing channels at market prices prevailing during the relevant spot months. Deliverable supply would not include supplies that could be procured at unreasonably high prices or diverted from non-standard locations.[11]

The NGSA is concerned that the Commission might underestimate deliverability of natural gas by not accounting for sources like natural gas storage and liquefied natural gas ("LNG") shipments deliverable to Henry Hub. The U.S. natural gas market is a highly efficient market, with a well-developed transportation system to move gas from production, storage, and LNG shipments as needed.[12] The Commission must adequately account for such sources in fixing the position limit levels.

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[8] The Commission has specifically invited comment regarding this particular issue. *See* NPRM at 4758 ("[H]ow broadly or narrowly should the Commission consider what constitutes deliverable supply?").
[9] NPRM at 4758.
[10] NPRM at 4757.
[11] NPRM at 4758.
[12] For example, at the beginning of the winter heating seasons in October 2009 and October 2010, there was approximately 3,800 billion cubic feet of gas storage. *See* Energy Information Administration, *Weekly Natural Gas Storage Report*, at http://ir.eia.gov/ngs/ngs.html.

IV. The Bona Fide Hedge Exemption Provisions Are Overly Restrictive and Unnecessarily Burdensome.

A. The Bona Fide Hedge Exemption Must Provide Adequate Flexibility to Accommodate Hedging on a Portfolio, Rather Than Individual Transaction, Basis.

The Commission should modify the bona fide hedge exemption provisions in section 151.5 of the proposed rule to provide adequate flexibility for market participants to manage their hedges on a portfolio, rather than individual transaction, basis. The common practice in the natural gas and many other industries is to maintain hedge positions against a portfolio of physical assets and related positions, as opposed to holding hedge positions that are neatly correlated to individual physical transactions. The market participant placing a hedge in this manner constantly reevaluates the hedge in light of multiple shifting market forces, in order to optimize the value and minimize the risk associated with its overall portfolio. The Commission should modify its proposed rule to recognize that bona fide hedge positions do not need to be tied to individual physical transactions or positions, in order to accommodate the need for, and the efficiencies gained by, this portfolio approach to hedging.

B. The Bona Fide Hedge Exemption Reporting Requirement Should Require Monthly, Not Daily, Reporting.

The reporting requirements for claiming the bona fide hedge exemption are overly burdensome and must be modified to bring compliance costs down to a reasonable level, which can be done while still providing the Commission an adequate picture of hedging in the derivatives marketplace. The proposed reporting requirements associated with the bona fide hedge exemption are overly burdensome and, as such, will effectively make the exemption unreasonably and unnecessarily, if not prohibitively, expensive. As Congress has made clear, regulators "must not make hedging so costly it becomes prohibitively expensive for end users to manage risk."[13] A reporting rule that makes hedging overly costly will result in eroded protections to end users and the economy as a whole, contrary to Congress's intent.

Under sections 151.5(b) and 151.10(a)(2) of the propose rule, traders relying on the bona fide hedge exemption must submit the following information to the Commission in *daily* reports:

(1) The cash market commodity hedged, the units in which it is measured, and the corresponding referenced contract that is used for hedging the cash market commodity;

(2) The number of referenced contracts used for hedging;

(3) The entire quantity of stocks owned of the cash market commodity that is being hedged by a position in a referenced contract;

[13] Letter from Sen. Christopher Dodd and Sen. Blanche Lincoln to Rep. Barney Frank and Rep. Colin Peterson 1 (June 30, 2010) (the "Dodd-Lincoln Letter").

(4) The entire quantity of open fixed price purchase commitments in the hedged commodity outside of the spot month of the corresponding referenced contract;

(5) The entire quantity of open fixed price purchase commitments in the hedged commodity in the spot month of the corresponding referenced contract;

(6) The entire quantity of open fixed price sale commitments in the hedged commodity outside of the spot month of the corresponding referenced contract; and

(7) The entire quantity of open fixed price sale commitments in the hedged commodity in the spot month of the corresponding referenced contract.

Such a daily reporting requirement will impose significant administrative costs on traders making use of the hedge exemption, as well as on the Commission itself.

As an alternative, the Commission has asked whether the reporting requirement should be limited to when a trader's position either first exceeds a limit and when a trader's hedging need increases, with monthly summaries while the trader's position remains in excess of the limit.[14] NCGA and NGSA support this alternative, which will lessen the administrative burden on traders and the Commission significantly while still providing an adequate picture of hedging activity in the marketplace—particularly when the Commission has other means, such as real-time reporting data, to monitor trading activity in the derivatives markets. In implementing the monthly summary requirement, the Commission should coordinate with the concerned industries regarding the timing of the monthly reporting requirement vis-à-vis the timing of the monthly close period with respect to the concerned contracts, to avoid making the reporting requirement unnecessarily burdensome.

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[14] NPRM at 4761.

V. Conclusion

As identified above, the Commission's proposed rule on position limits for derivatives would (1) unnecessarily and inappropriately limit trading in cash-settled spot month contracts and cash-settled and physically-delivered non-spot month contracts and (2) overly restrict portfolio-based hedging and make use of the bona fide hedging exemption unreasonably expensive due to overly burdensome reporting requirements. Accordingly, NCGA and NGSA have identified several modifications and clarifications to the proposed rule that are necessary to bring it into conformity with the Act and with Congress's intent.

Continued efficient investment in a sound, robust energy market is critical to the economy and energy producers. Energy costs are as critical to American corn farmers as the integrity of corn markets. NCGA and NGSA are committed to working together to bring natural gas and corn to the economy and to bring workable Dodd-Frank Act implementation solutions to table at the CFTC. NCGA and NGSA appreciate the opportunity to provide these comments. Should you require further information, please do not hesitate to contact us.

Sincerely,

National Corn Growers Association
Natural Gas Supply Association