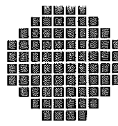

KANSAS CITY
BOARD OF TRADE

March 28, 2011

Submitted online at
www.cftc.gov

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

Re: Position Limits for Derivatives - RIN 3038-AD15 & AD16

Dear Mr. Stawick:

The Kansas City Board of Trade ("KCBT") appreciates the opportunity to offer comment on the Commission's proposed rulemaking regarding position limits for derivatives. KCBT is a designated contract market ("DCM") for futures and options contracts and therefore directly impacted by position limit regulations.

Before delving into more detailed comments in response to various aspects of the proposed limit rules, we wish to first address a minor housekeeping item. Proposed Regulation 151.3(a)(2) defines KCBT's wheat futures contract spot month as beginning as of the close of business **"three"** business days prior to the first trading day of the delivery month. This definition is inconsistent with KCBT Rule 2008.00(a)(1), which specifies that the spot month begins as of the close of business **"two"** business days prior to the first trading day of the delivery month. We ask that the Commission revise its spot month definition for grains contracts to be consistent with exchange rules.

Position Limit Parity Between Wheat Futures Contracts. As we have done over the years when the Commission has considered changes to the position limits for the enumerated agricultural commodities contracts in § 150.2, KCBT requests that position limit parity be maintained across the three wheat markets for the reasons stated below:

Competition – Disparate limits for the three wheat contracts could significantly impair a market's ability to compete for speculative interests critical to the liquidity requirements necessary to maximize contract utility for commercial market hedgers. Volume growth and liquidity is dependent upon a contract's ability to attract non-commercial market participants to provide tighter markets resulting in greater hedging efficiency. Disparate limits can have the effect of directing liquidity to certain markets through regulatory position limit arbitrage. In a November 7, 1986 comment letter on the then proposed speculative position limit changes, the Chicago Board of Trade acknowledged that competitiveness could be affected by disparate limits:

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> *"The (Chicago) Board of Trade believes that Federal speculative position limits for the same commodity should not vary by contract market. A system of different position limits applied to different contract markets in the same commodity serves no economic purpose, except to give one exchange a competitive advantage over another. Further, if such a change were to be made, it may adversely affect the hedging opportunities of a particular futures market. The viability of a futures contract market depends on the presence of both hedgers who wish to transfer price risk and speculative traders who accept that price risk and who, in effect, provide liquidity to the hedgers. Adopting a system of variable position limits by contract market would predetermine the extent of growth of speculative traders in any contract market. This system may unduly restrict a particular contract market's ability to provide liquidity to hedgers at that contract market and thus put that contract market at a competitive disadvantage with respect to all other contract markets in the same commodity. In the interest of fair trade, the (Chicago) Board of Trade believes that position limits for the same commodity should be the same for all contract markets."*

Intermarket Spread/Arbitrage. Different limits for the same type (but not necessarily variety) of commodity could dramatically impact the growth or potential for risk mitigating strategies between the contract markets. In the case of wheat, this is particularly critical given the nature of the three differing varieties. Having three varieties provides not only additional opportunities for market participants to reduce risk through spread trades, but also provides opportunity for hedging and trading strategies between markets in response to domestic or global economic factors that could result in varying impacts on differing varieties of wheat. Recent examples include the Russian export ban, the flooding in Australia and geopolitical unrest in the Middle East. Disparate limits between markets would only serve to unfairly restrict one leg of these intermarket strategies.

Underlying Cash Market. Position limits based on open interest inherently results in disparate limits without consideration of other material factors such as the underlying production of the commodity, the level of activity in the cash market trade in such commodity, both domestic and export, and the amount of cash commodity in deliverable position supporting such futures contract. Ignoring such factors creates an unnecessary impediment to expanded market use, in that a larger underlying cash market should be capable of supporting increased futures market participation.

Trader Position Holdings. Another material consideration for position limits based other than on open interest would be whether a market with lower levels of open interest has a disparate concentration of non-commercial open interest relative to markets with larger open interest. In the case of wheat, as evidenced by the Commission's weekly "Commitment of Traders" report, wheat markets with a lower level of open interest have a higher percentage of commercial participation compared with markets with larger open interest. This statistic suggests that the markets with lower open interest should be capable of handling increased non-commercial participation. Parity in limits across wheat markets would insure equitable opportunity for increasing such participation for the benefit of not only commercial hedgers, but all market participants through increased growth and liquidity. To be sure, all three wheat markets have enjoyed tremendous growth in volume and open interest in recent years, during which time limit parity was maintained. In fact, limit parity between KCBT and CBOT wheat futures contracts has been maintained since position limits were first legislated by Congress in 1938, during several increases over the years by the CFTC, and through today.

Methodology for Determining Position Limits. As explained in detail above, KCBT takes exception to any position limit methodology based on open interest. KCBT supports legacy numeric limits with parity across wheat markets. As stated earlier, given the tremendous growth in both volume and open interest in all three wheat markets in recent years, we support and encourage the Commission to adopt equal and reasonable legacy (specific numeric) position limits for the enumerated wheat contracts that will continue to serve the needs of our markets and promote expanded market use. The creation of disparate limits between these markets will only serve to impede rather than foster such growth. In addition, unreasonably restrictive limits will only serve to aide overseas markets in promoting their contracts as replacements for the U.S. wheat futures global benchmark contracts, similar to the movement of late to shift away from the U.S. dollar as the global currency. Such a transfer of liquidity and benchmark status overseas would provide a disservice to U.S. wheat producers through the reduction of liquidity and hedge effectiveness.

Aggregate Position Limits. KCBT understand and appreciates the Commission's efforts in promulgating rules to oversee the previously unregulated over-the-counter markets. As a part of this effort, aggregate position limits across like commodities contracts traded on both futures and swaps markets seem appropriate. However, as repeatedly stated and detailed above, KCBT takes exception to the methodology of position limits based on open interest. In addition to our arguments above to such a methodology, the approach proposed in § 151.4(e) is unnecessarily cumbersome and complex. Specific numeric limits offer the market clarity and ease of application without concerns for annual changes that may affect open market positions. In addition, it unnecessarily requires both marketplace and Commission resources to accumulate and report the information necessary to calculate the annual position limit changes. Numeric limits do not require such resources.

In advocating numeric limits, we offer the Commission for consideration, an alternative approach to the establishment of all-months-combined contracts of the same class individual and aggregate limits. Each contract within the same class would have a separate, distinct and reasonable numeric limit with an overarching higher aggregate class limit. This method insures that each distinct market is not unfairly restricted by participation in other markets within a class, while maintaining overarching limits across the class that limit excessive overall positions. Many of the reasons stated above advocating position limit parity across wheat markets are valid in establishing position limits across contracts of the same class. As an example, each contract within a class is assigned an all-months-combined numeric limit of 10,000 contracts, with an overarching aggregate class all-months-combined total limit of 25,000 contracts. Position limits structured in this fashion would be much more straightforward, easier to monitor, and would not require periodic changes to position limit tracking software, as would be required under § 151.4(e).

Spot Month Position Limits. KCBT agrees with the Commission that spot month position limits are an important tool in avoiding the potential for non-commercial interference with the orderly liquidation of a contract month by encouraging the liquidation or rolling forward of speculative positions prior to such contract month's delivery period. However, we take exception to a spot month formula based solely on deliverable supply, which will result in disparate limits across wheat markets and diminish liquidity through inter-market spreading during the spot month. The existing conservative spot month limits across the wheat markets have been in place for many years without any issues or concerns.

KCBT also takes exception to the Commission's proposed "conditional spot month position limit" for cash-settled contracts. Though precedent has already been established, KCBT objects to the idea of a contract market leveraging liquidity off of an established physical delivery futures contract through the establishment of a referenced contract that financially settles to the core physical delivery contract. This precedent however, does not mean that the Commission should further exaggerate this inequity by creating an uneven spot month position limit playing field based solely on a contract's settlement mechanism. To do so is wholly unfair for several reasons.

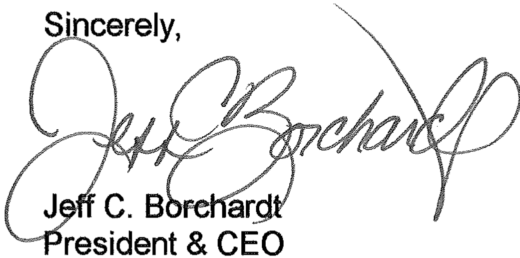
First, it is unfair to the physical delivery market to be restricted in comparison to the copycat contract. The time, resources and capital it takes to launch, develop and continually monitor and enhance the benchmark physical contract for the benefit of the core commercial market participants (*bona fide* hedgers) should alone earn it the right to compete fairly and equally with look-alike referenced financial contracts. These look-alike contracts already enjoy the advantage of not having to maintain the resources necessary to oversee a physical delivery commercial marketplace. Why then would the Commission even consider imbedding an additional advantage in the form of spot month position limits?

Second, the spot month is an important time for *bona fide* hedgers in rolling, liquidating or making/taking delivery of contracts. Given that the referenced financial contracts settle based on or relative to the physical contract, it is possible (particularly during the spot month when open interest is already low and in liquidation mode), that the higher spot month position limits in the financial contract could disrupt or unduly influence the price discovery function of the physical contract (the "tail wagging the dog" effect).

Third and finally, the higher spot month limit for the financial contract unduly restricts the physical market's ability to compete for spot month speculative trading interests, which provide additional liquidity to commercial market participants (*bona fide* hedgers) as they unwind or roll their positions forward. For these reasons, we ask that the Commission maintain parity in all position limits (including spot month limits) between core physical and look-alike referenced financial contracts.

In closing, KCBT reiterates its appreciation for the opportunity to provide comments on the Commission's proposed rulemaking regarding Position Limits for Derivatives (RIN 3038-AD15 & 3038-AD16). Please contact me at 816-753-7500 if you have any questions or would like to discuss our comments.

Sincerely,



Jeff C. Borchardt
President & CEO