Alternative Investment Management Association

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

Submitted via http://comments.cftc.gov

28 March 2011

Dear Mr Stawick,

CFTC request for comment on Position Limits for Derivatives

The Alternative Investment Management Association (AIMA)[1] appreciates the opportunity to provide comment on the Commodity Futures Trading Commission's (the 'Commission') request for comments on the proposed position limits for 28 core physical-delivery contracts and their "economically equivalent" derivatives. The proposed rules aim to implement section 737 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the 'Dodd-Frank Act'), which amendments section 4a(a) of the Commodity Exchange Act (the 'CEA') and requires the Commission to set position limits in line with that section.

Introduction

AIMA members are active participants in the US commodity markets, and invest for a number of reasons, including as an uncorrelated hedge to investments in other markets on behalf of their investors. They play a role providing liquidity to the market to aid price discovery, and act as willing buyers for producers and willing sellers for end users. We believe that participation of financial institutions in the commodity markets, including the derivatives market, is a genuine and useful market activity and that there is little evidence that their activities have caused additional volatility in the markets or have caused higher prices. Commodity markets, like other markets, determine their prices via the supply and demand mechanism, and where examples exist of increasing prices and volatility these can usually be linked to underlying factors such as the success of an agricultural crop, the discovery of new mineral wealth or new demand from emerging nations.

We note however that Congress has made a decision to place certain limits on trading in the commodity markets, and therefore we are keen to work with the Commission to ensure that position limits are effective but still, where possible, allow the commodity markets to function and determine accurate prices. To the extent that the Commission's proposals aim to address market abuse or market manipulation in any form, we give our full support to the Commission in this regard. For genuine market activity, the Commission must ensure that position limits are set and defined in such a way as to ensure that markets remain efficient, liquid and transparent, governed by supply and demand, and produce a fair settlement price. To this end, we would encourage the Commission to consider the discretion it is provided under section 737 to establish specific position limits only where they are "appropriate" to meet the goals of this section. If specific limits are considered appropriate the Commission should introduce such limits when it has available market data to set the limit. Where possible, it is also important that position limit levels are coordinated with the Commission's

[1] AIMA is the trade body for the hedge fund industry globally; our membership represents all constituencies within the sector – including hedge fund managers, fund of hedge funds managers, prime brokers, fund administrators, accountants and lawyers. Our membership comprises over 1,100 corporate bodies in over 40 countries, with 11% based in the US and over 30% of AIMA members' total assets under management (AUM) managed by US investment advisers.

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international counterparts, including those in Europe and Asia, to accomplish the goal as stated at section 737 "that any limits to be imposed by the Commission will not cause price discovery in the commodity to shift to trading on the foreign boards of trade".

AIMA believes the Commission has taken a generally sensible approach to implementing the position limits but we wish to raise certain issue and seek certain clarifications, particularly in relation to aggregation of traders' positions, that will ensure that the proposed rules are consistent, fair and are easy to comply with, without unintended consequences for market users.

AIMA's detailed comments

Spot-Month Position Limits

The Commission proposes to set an aggregated spot-month positions limit that is 25% of the established deliverable supply, with possible adjustments to the limit thereafter. The limit is appropriate in light of its long standing use as a limit for designated contract market (DCM) spot-month position limits. However, we believe this limit should be kept under review to ensure the limit remains appropriate and effective to prevent 'corners and squeezes' at settlement. The limit would be applicable regardless of the form that the contract takes or the venue of execution, which we accept is necessary and avoids complicating the limits via requiring separate limits for listed and unlisted trades.

As one of the goals of the limits is to ensure there is not unnecessary 'congestion' surrounding a contract in the delivery month, which causes its price to increase significantly before settlement, we believe looking at limits for physically-settled and cash-settled contracts is important. Positions taken in physically-settled contracts will have a direct impact on the market price of the underlying commodity. Cash-settled contracts will have a less direct effect and thus we agree that it is beneficial to have a limit multiple times that of the physically-settled contract to deter market manipulation or for the Commission to consider whether the limits for cash-settled contracts are appropriate at all. The direct effect that cash-settled derivatives may have on price discovery is uncertain and we would encourage the Commission to place initial cash-settled contract position limits at a higher level (beyond the proposed five times spot-month limits), to study the effects of cash-settled contracts and then lower the limits over time if thought necessary. This method would ensure that market liquidity and price discovery are not affected whilst a correct limit level may be found.

AIMA supports the increased position limits for cash-settled contracts under the conditional-spot-month position limit. Nevertheless, we are concerned about the conditions that must be fulfilled before the higher limit may be used. The conditions are such that the trader may have the five times spot-month limit only where they, among other criteria, do not hold or control any positions in physically-delivered contracts referencing the same commodity. AIMA is concerned that this approach will result in parties being prohibited from holding physically deliverable contracts, and that this will in turn cause a large reduction in liquidity in the physically-delivered market. Reduction of liquidity will have the effect of causing physically-delivered contracts to become more susceptible to movements in price, which the position limits are, in part, designed to guard against. This rule seems to have some potentially serious negative effects on the physically-delivered market, but without any corresponding benefit that could justify the approach. The rule further seems strange in that one of the other conditions of the conditional limit is that the trader may hold up to 25% of the physical commodity itself. A further effect may therefore be that investors will migrate to the physical commodity markets themselves resulting in greater price pressure in the physical commodity. If the Commissions' concern is that holding large cash-settled positions at the same time as holding physically-settled positions may provide opportunities for inter-market manipulation, we believe that the Commission should instead tackle this via market surveillance and anti-market manipulation rules, rather than as a condition on the conditional-spot-month position limits.

If the goal of the limits is ensuring efficient price discovery on a particular commodity, then it would seem unnecessary to have separate limits for commodities which would have a delivery at a different location. The price of a commodity at one delivery location will have an important bearing on the price of a commodity at a different location. An important consideration for the Commission is to ensure that it is able to effectively

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determine an accurate estimate of deliverable supply. We agree that the Commission should use the estimates as provided by the DCMs in the first stage of the implementation. Where further information is made available to the Commission by the implementation of the second stage, the method by which it will determine its own estimates of supply must be made clear to allow longer term planning by market users who will need to be able to think about their future positions in relation to possible future limits. The Commission should rely on the DCM estimates wherever possible in this regard, as the DCMs have developed sufficient experience in this regard over time. When the Commission deems it appropriate to provide its own estimates, these should be based on an estimate of the supply which is genuinely possible to be delivered and which would contribute to the price discovery mechanism. This may include all supplies available in the market at all prices and at all locations, as if a party were seeking to buy a commodity in the market these factors would be relevant to the price.

Non-Spot-Month Position Limits

Although AIMA understands that limits within the spot-month may be effective to prevent 'corners and squeezes' at settlement, the case for placing position limits in non-spot-months is less convincing and has not been made by the Commission. We note that the Dodd-Frank Act at section 737 states that the Commission shall set position limits "as appropriate" and "in its discretion" to diminish, eliminate, or prevent excessive speculation; deter and prevent market manipulation, squeezes, and corners; ensure sufficient market liquidity for bona fide hedgers; and ensure that the price discovery function of the underlying market is not disrupted. This mandate from Congress provides the opportunity for the Commission to consider whether the position limits are appropriate in the non-spot-months and we would encourage the Commission to conduct an evidence-based assessment of the likely impact of these limits before introducing them.

If the Commission proceeds with these limits as proposed, AIMA supports the Commission in choosing to delay the introduction of non-spot-month positions limits until sufficient data has been collected to be able to properly assess the open interest. To do otherwise would risk setting inappropriate limits that could reduce liquidity in the market and possibly create the volatility and high prices that the limits are designed to prevent. As stated above in relation to spot-month limits, it may be appropriate to set limits higher than they may initially be expected to be set at. Although we have no particular issues with the 10% limit for the first 25,000 contracts, it may be more appropriate to start with a 5% limit for contracts over 25,000 until a real assessment on the impact of the new limits can be conducted. If this is found to be too high on an objective assessment, the Commission may later consider a reduction of the 5% element of the limit. The Commission questions whether the swap class should be further divided into cleared and uncleared swaps. Factoring in clearing to the limits would unnecessarily complicate the proposal. AIMA fully supports the Commission in its efforts to encourage clearing of swaps, but using categories of cleared and uncleared swaps to subdivide a swaps class is not appropriate when setting position limits as it does not relate to the method of trading or form of the contract, which may be relevant to the price. Additionally, swaps which are eligible for clearing may change from time to time as a CCP offers to clear certain swaps or the Commission approves certain swaps for mandatory clearing – this makes setting position limits based on whether a swap is cleared or not difficult and burdensome from a compliance perspective.

The non-spot-month position limits, as proposed, split out into 6 different limits combining the two classes of contract (futures and options contracts, and swaps contracts), aggregate of the two classes and limits for each month as well as an all-month limit. The reasons for each of the limits are explained in the Commission's proposed rules, however as proposed this would seem to be an unnecessary level of complexity given the intended goals. It may be necessary to have both single-month and all-month limits, but a simplification can be achieved by either removing the aggregate limits or just having aggregate limits (as is done with spot-month limits). The aggregate limits have been proposed as there is concern about parties holding offsetting positions across the classes that make the party neutral but appearing to hold excessive positions in the market. Offsetting positions are also possible within the swap class as well as across the classes, and large offsetting positions are unlikely to be taken except in relation to bona fide hedging (which is exempt). Either an aggregated limit or a limit for each of the class should be used. Removal of unnecessary limits helps cut down on the already high compliance burden for non-exempt firms, and complications for the Commission in enforcing these limits.

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For legacy positions limits, these have developed over time and have succeeded in their goals of ensuring sufficient market liquidity and prevent parties taking positions which distort price discovery. We agree that it makes sense to increase the single-month limit in line with the existing all-months-combined limit to conform the legacy limits to the proposed Federal position limits. The all-month-combined limit levels however should be retained but, as with the other limits, be kept under review to ensure that the limits meet a correct balance that ensures proper price discovery and market liquidity. Where parties have established positions in good faith prior to the introduction of the proposed rules these should be permitted after the new limits' introduction, including where parties "roll over" contracts before they reach the spot-month in order to maintain position allocations.

Exemptions for referenced contracts

The exemption from positions limits for *bona fide* hedging transactions or positions is an important element of the position limits regimes and allows necessary positions to be taken by certain market participants to reduce their overall risk exposure. For this reason, we support the Commission's proposal to fully implement the Dodd-Frank Act's *bona fide* hedge exemption, obtainable through the use of futures contracts, options and swaps. As market participants currently utilise the *bona fide* hedging exemption, the exemption in relation to the new proposed Federal position limits should as closely as possible align with the existing and understood definition. This should include in certain circumstances financial hedging, as is currently permitted under the CEA exemption (e.g., non-speculative positions taken to hedge other financial activities), and we do not believe anything in the Dodd-Frank Act prevents this interpretation.

Position Visibility

AIMA believes the Commission should be able to have proper oversight of the market and therefore it is important that the Commission is able to know, where necessary, the positions of the largest traders in given markets. We are aware that the European Commission, for example, has recently consulted on a 'position management' regime in its review of the Markets in Financial Instruments Directive (MiFID) that would operate on similar lines to the position visibility regime proposed. This is likely to be the most effective way to control large positions in the market, as it will give the Commission opportunity to engage with parties building positions in certain commodities and allow them to explain their strategies and motivations. The Commission also recognises a position accountability regime for certain excluded commodities traded on designated contract market (DCM) (see below).

Our main concern is to ensure that information on positions is, where not otherwise reported publicly, kept confidential by the Commission. Any publication is likely to damage the commercial interests of those parties taking the position, but may also cause other parties to follow the strategy of others and lead to multiple parties taking large positions in a market, collectively affecting the market price, where this would not otherwise happen.

The setting of position visibility limits to capture the top set of traders in a market is one possible approach to setting the limits. A further sensible approach could be to set the visibility limits as a percentage of the position limits, which will vary as the limits continue to be assessed. Although we are less concerned with the visibility limits for positions, as these will not affect market liquidity and price discovery, we question why it is necessary at the outset to keep under closer scrutiny oil and gas contracts compared with other markets. It is likely that different commodity contracts will vary in importance over time and the Commission should set and adjust limits so that they may properly review positions being built at any one time in any contract of concern. It seems unnecessary to exclude, as a rule, referenced agricultural contracts, and the Commission should consider including these at a sufficiently high level for later adjustment where necessary.

Aggregation of Accounts

Whilst it is necessary to aggregate some positions managed by a single trader to prevent circumvention of the position limits, we are particularly concerned about the possible effects of having to aggregate positions held

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across separately managed commodity pools.

The assets and funds of a commodity pool or managed account are directly owned by the investors in the pool or investor in the managed account and thus it is they who hold the positions for the purposes of the proposed position limits. They however do not control trading which is done at various levels by the CPO who operates the commodity pool and controls the pool vehicle and the CTA which has trading teams making the day-to-day decisions on the investments of the pool or managed account.

We are concerned by the proposed requirement for investors with a significant equity interest in a commodity pool to aggregate all positions of the commodity pool with the positions they have in other commodity pools or via direct trading. This causes the concern that as the investor will not control the trading of the pool, they will not be able to ensure that their position held as part of the pool, added to their positions held outside of the pool, will remain under the federal position limits. The positions of the pool will have to be under the federal position limits as they are controlled by the CPO and CTA, as will the investor's (as trader) position outside of the pool, however it may be easy to very quickly breach the position limits in aggregate for large investors with multiple methods of investing (e.g. large institutional investors including pension funds who make multiple investments to seek diversification of their portfolio of investments). Investors themselves will not likely know the day-to-day positions taken by the controllers of the commodity pool on their behalf and therefore it will be burdensome to adjust their other positions to stay under the proposed federal limit. To require the CPO/CTA to report the daily positions to the investors will be equally burdensome and may also be too late at any one time to prevent a breach of the limits if a report is made only after a trade is executed. The result is such that many investors will be unwilling to take a large equity interest in commodity pools in order to avoid the risk of breaching the proposed position limits. This can cause the number of independent traders to be reduced, with resulting effects for market liquidity and investor choice.

The exception to the aggregation rule in section 151.7(c) provides a limited exemption for a commodity pool participant where they have an ownership or equity interest greater than 10% of the pooled accounts or positions, where the pool operator has procedures that would prevent the investor having knowledge about the trading positions of the pool, where the investor has no control over the trading decisions of the pool and where the pool operator has received an exemption from aggregation on behalf of the investor (or investors within a class to which they belong). However, if that investor has an interest of greater than 25% of the equity or ownership of the pool, they must aggregate the entire position of the pool with all other positions (either gained in further pools or on its own account). A change has been made to the similar exemption in Part 150 of the CFTC Regulations in that the 25% aggregation rule now applies to any commodity pool, not just those who's operators are exempt from registration as a CPO with the Commission under § 4.13 (i.e. private pools). For those investors with greater than 25% interest in a commodity pool, they are now therefore effectively prohibited from having an interest of greater than 25% in any other pools. The existing rules under Part 150 are more effective in that, whilst having the same safeguards for exempt pools (including that the investor will not know the positions of the pool or control trading), the Commission could regulate non-exempt pools via the CPO and oversee positions that may be being built and engage with the CPO as to the reasons for establishing the position. This proposed change is heavy handed and unnecessary to achieve the purpose of overseeing and limiting parties in their ability to get round the proposed position limits.

For traders trading their own assets, many institutions (including CTAs and CPOs) have in the past sought to reply on the 'independent account controller exemption' present in Part 150 that allows them to allocate control over those assets to independent trading teams who are operationally independent of each other and have no knowledge of the teams' trades and positions, and thus collectively hold positions above the federal position limits. This exemption has worked without issues for many years and has reflected both the way in which financial entities are structured and controlled, and a common sense approach to position limits whereby (a) accounts are separately controlled and (b) independent account controllers have no knowledge of the trading decisions of other independent account controllers, which means that there is no opportunity to intentionally and purposefully build positions which circumvent the federal position limits. This exemption has also been used in relation to large multinational organisations, which have independent business units (or different legal entities) each active in futures trading for differing reasons. These entities are operationally independent from

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one another and trade for fundamentally different reasons. Some of AIMA's members are part of large financial groups that include not only asset management subsidiaries and CTAs, but also Futures Commission Merchant subsidiaries, and investment banking subsidiaries who trade for commodities corporate hedging or market-making. Trading decisions taken by each such subsidiary are totally independent from the other subsidiaries within the group, are driven by unrelated processes, and are not shared across the Group of subsidiaries / entities. They have therefore been able to establish appropriate policies and processes to keep those trading strategies separate and have relied upon the independent account controller exemption.

Instead of reintroducing the independent account controller exemption (which the Commission has intentionally excluded), we would urge the Commission to instead consider changing the proposed 'owned non-financial entity exemption' at section 151.7(f) into an 'owned entity exemption' and thereby allow entities and large investors in commodity pools that are clearly independent – having no knowledge of trading decisions, no shared control over trading and written policies and procedures to facilitate this – to qualify for an exemption from aggregation in the same way proposed for non-financial entities. The equal treatment for financial and non-financial entities would reflect a fair and common sense approach that takes account of the need to prevent wilful avoidance of the proposed position limits and the benefits to the market of trading from both financial and non-financial entities.

Without such exemptions the aggregation of position limits for CTAs, CPOs and other financial institutions will be burdensome and difficult to comply with, and may have effects including a reduction in legitimate trading activity and an overall reduction in market liquidity, resulting in poorer price discovery and greater price volatility.

Procedure for applying for exemptions from the position limits and exemptions from aggregation of position limits

The Commission proposes that where a trader wishes to utilise one of the available exemptions it must first apply to the Commission for permission to use the exemption. We appreciate that the self-executing nature of existing position limit exemptions does not allow the Commission to review the use of every exemption, however the requirement to apply for an exemption in all cases is likely to be unworkable. The proposed rules are unclear about when the application for exemption must be made, and the changing nature of business structures and the parties with whom traders interact may require regular filings (e.g. as an investor, is an exemption necessary for each investment it makes?). The Commission is likely to be overwhelmed with details and parties applying for exemptions from rules, and this is both administratively burdensome for the Commission and is likely to be unmanageable for smaller traders and investors who are not ever likely to breach the limits in any case but must file an application to ensure its compliance with the rules. In particular, we feel that the requirement to apply for an exemption from aggregation (with the accompanying annual reapplication requirement) in the case of investors holding a large equity interest in a commodity pool is not desirable.

Registered entity position limits

Registered entities, including DCM and swap execution facilities (SEFs), may wish to impose their own position limits to control prices and volatility on their markets, and we agree that these should not be such as to affect the limits imposed by the proposed rules. As stated above, we believe a preferable option for many markets is likely to be a position accountability regime, as the Commission proposes for excluded commodities trading on a DCM subject to certain conditions. We therefore support that the Commission recognises that position accountability may be more appropriate for certain contracts with lower levels of open interest.

Conclusion

Overall, we believe the Commission has proposed sensible rules for implementation of Federal position limits as required by the Dodd-Frank Act, and we support the phased implementation of the specific limits which will take account and only take effect upon the provision of accurate market data. However, as stated we are concerned about the aggregation of limits for certain traders and believe these rules must be rethought. To achieve the

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goals of section 737 of the Dodd-Frank Act we would also encourage substantial international cooperation and coordination to avoid commodity market trading activity moving from US markets to foreign boards of trade.

We thank you for this opportunity to comment on the Commission's proposed rules and are, of course, very happy to discuss with you in greater detail any of our comments.

Yours sincerely,

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