AMERICAN PUBLIC GAS ASSOCIATION

March 28, 2011

VIA E-MAIL: secretary@cftc.gov

David A. Stawick
Secretary
Commodity Futures Trading Commission
1155 21st Street, N.W.
Washington, D.C. 20581

Re: "Position Limits for Derivatives; Proposed Rule," 76 *Fed. Reg*. 4752 (January 26, 2011).

Dear Mr. Stawick:

The American Public Gas Association ("APGA") appreciates the opportunity to comment on the Commodity Futures Trading Commission's ("Commission") "Position Limits for Derivatives; Proposed Rule," 76 *Fed. Reg*. 4752 (January 26, 2011) ("Notice"). The Notice proposes to implement speculative position limits, as required by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"), for certain physical commodity derivatives, certain physical commodity futures and option contracts executed pursuant to the rules of designated contract markets ("DCM"), physical commodity swaps that are economically equivalent to such DCM contracts, and aggregate position limits that would apply across different trading venues to contracts based on the same underlying commodity. The Notice also proposes several related exemptions, new account aggregation standards, new visibility regulations, and regulations establishing requirements and standards for position limits and accountability rules to be implemented by registered entities.

APGA

APGA is the national association for publicly-owned natural gas distribution systems. There are approximately 1,000 public gas systems in 36 states and over 700 of these systems are APGA members. Publicly-owned gas systems are not-for-profit, retail distribution entities owned by, and accountable to, the citizens they serve. They include municipal gas distribution systems, public utility districts, county districts, and other public agencies that have natural gas distribution facilities.

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Proposed rules in general

The Commission proposed to set speculative position limits on energy commodities that would apply both across markets as well as to each market individually. Section 4a(a)(1) of the Commodity Exchange Act, 7 U.S.C. §1 et seq. ("Act"), as amended by the Dodd-Frank Act, authorizes the Commission to extend position limits beyond futures and option contracts to swaps traded on a DCM or swap execution facility ("SEF"), swaps that are economically equivalent to DCM futures and option contracts with position limits, and swaps not traded on a DCM or SEF that perform or affect a significant price discovery function with respect to regulated entities.[1] New Sections 4a(a)(2)(B) and 4a(a)(3) of the Act empower the Commission to set spot-month, single-month and all-months-combined limits for DCM futures and option contracts on "exempt" and "agricultural" commodities.

The Commission is proposing to establish position limits in two phases. The first phase would involve adopting spot-month limits based on current levels set by DCMs; then, in phase two, the Commission would establish non-spot-month limits based on open interest levels and Commission-determined spot-month limits. Because it has not routinely collected data regarding most swap markets, the Commission does not currently have the open interest and market structure data necessary to apply a formula-based non-spot-month position limit. Accordingly, the Commission is now proposing a formula for setting the non-spot-month position levels, which is derived from current rules that apply to agricultural commodities. In addition, the Commission has proposed an exemption for "*bona fide* hedging transactions." As data becomes available, the Commission will calculate the limits to be established under the formula that it is proposing to adopt.

In Section 4a of the Act, Congress recognized that "Excessive speculation in any commodity under contracts of sale of such commodity for future delivery…causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity is an undue and unnecessary burden on interstate commerce in such commodity." Congress thus instructed the Commission to fix speculative position limits as "necessary to diminish, eliminate or prevent such burden." In the Notice, the Commission reiterates its own findings that large speculative positions "can result in sudden changes to commodity prices that would otherwise not prevail if traders' positions were more evenly distributed among market participants." Based on these findings, the Commission has proposed aggregate speculative position limits that apply across multiple markets.

These rules were proposed following an opportunity for the public to submit comments in advance of the Commission's proposal. APGA applauds the Commission for accepting such advance comments and for bringing a high degree of transparency and public involvement to the discussion of the issue of speculative position limits. APGA agrees that the application of an

[1] Specifically, new Section 4a(a)(6) of the Act requires the Commission to apply position limits on an aggregate basis to contracts based on the same underlying commodity across: 1) DCMs; 2) foreign boards of trade, if the contracts are price-linked to a DCM or SEF contract and made available from within the United States via direct access; and 3) significant price discovery function swaps.

aggregate limit across markets on which contracts on the same commodity are traded is necessary to reduce or diminish the recent unwarranted price volatility in the futures and option markets for natural gas, and concurs with Congress's findings and with the Commission's proposal to adopt Commission-set aggregate speculative position limits. APGA does not object to the Commission's proposal to base non-spot speculative position limits on open interest, but as explained in greater detail below, believes that the non-spot month limits being proposed by the Commission are too high to be effective. Moreover, APGA does not object to the Commission's decision to delay adopting non-spot-month position limits until it has accumulated the data that it believes is necessary. However, APGA questions the Commission's proposal to adopt the same high limits for individual non-spot months as for all-months-combined. This is a departure from its recent proposal for speculative position limits and from many exchange-set position limits.[2]

History of speculative position limits under the Commodity Exchange Act

Systemized trading in contracts for the future delivery of agricultural commodities developed in the United States in the mid to late 1800s from an economic need for risk shifting. Glaring abuses were attendant with the advantages of trading; these included price manipulations, market corners and extreme and sudden price fluctuations on the organized exchanges. These abuses stirred repeated demands for legislative action to prohibit or comprehensively regulate futures trading. Although the first regulation of the grain futures markets dates from the 1920s,[3] the Commodity Exchange Act of 1936[4] was the first statute to comprehensively regulate the futures markets.

Section 3 of the Act as it existed before the 2000 amendments explained the statute's purpose in relevant part as follows:

> Transactions in commodities involving the sale thereof for future delivery as commonly conducted on boards of trade and known as "futures" are affected with a national public interest. Such futures transactions are carried on in large volume by the public generally and by persons engaged in the business of buying and selling commodities and the products and byproducts thereof. . . . The prices involved in such transactions are generally quoted and disseminated through the United States and in foreign countries as a basis for determining the prices to the producer and the consumer. . . . The transactions and prices of commodities on such boards of trade are susceptible to excessive speculation and can be manipulated, controlled, cornered or squeezed, to the detriment of the producer or the consumer. . . .

Section 4a of the Act, quoted above, echoes the Congressional finding of former Section 3.

The Commission in 1981 adopted a rule requiring all futures exchanges to impose speculative position limits for all commodities that were not subject to a Federal speculative

[2] *See* Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations, 75 Fed. Reg. 4144 (Jan. 26, 2010), *withdrawn* 75 Fed. Reg. 50950 (Aug. 18, 2010).
[3] *See* Grain Futures Act of 1922, Publ. L. No. 6-331, 42 Stat. 998 (1922).
[4] Act of June 15, 1936, ch. 545 §5, 49 Stat 1494.

position limit.[5] In so doing, the Commission explained the danger that unchecked speculative positions can pose to the markets, saying:

> It appears that the capacity of any contract market to absorb the establishment and liquidation of large speculative positions in an orderly manner is related to the relative size of such positions, i.e., the capacity of the market is not unlimited. Recent events in the silver market would support a finding that the capacity of a liquid futures market to absorb large speculative positions is not unlimited, notwithstanding mitigating characteristics of the underlying cash market.[6]

Subsequently, the Commission permitted a number of contracts to be exempt from the requirement that the exchange impose a speculative position limit, permitting instead that the exchange impose a "position accountability rule."[7] These exemptions were based on the liquidity of the futures and cash markets for such commodities. Tangible commodities, such as energy, were permitted to have a position accountability rule only for the back months; spot-month speculative position limits were still required. The position accountability exemptions were codified by the Commission at 17 C.F.R. §150.5(e).

Finally, Section 13201 of the CFTC Reauthorization Act of 2008 provided that various core principles shall apply to exempt commercial markets on which Significant Price Discovery Contracts ("SPDCs") are traded. Core Principle IV requires such an electronic trading facility to adopt position limitations or position accountability for speculators in SPDCs, taking into account positions in other agreements, contracts, and transactions that are treated by a derivatives clearing organization as fungible with such SPDCs.

The new authority provided to the Commission in the Dodd-Frank Act and the Commission's proposed rules pursuant to that new authority continue to build upon the foundation of these prior actions.

Necessity for Commission speculative position limits

As hedgers using both the exchange and the OTC energy markets, APGA's members value the role of speculators in the markets. We also value the different needs served by the futures exchanges and the swaps markets. As hedgers, public gas systems depend upon liquid and deep markets in which to manage our risk. Speculators provide needed liquidity and depth to the markets.

However, speculative trading strategies may not always have a benign effect on the markets. For example, the dramatic collapse of Amaranth Advisors LLC and the impact it had upon prices exemplifies the adverse impact that speculative trading interests can have on natural gas supply contracts for local distribution companies ("LDCs"). Amaranth Advisors LLC was a

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[5] The Commission subsequently modified this requirement, permitting contract markets to impose "position accountability rules" in lieu of speculative position limits for certain contracts, including energy contracts.
[6] Establishment of Speculative Position Limits, 46 Fed. Reg. 50938, 50940 (Oct. 16, 1981).
[7] *See* Revision of Federal Speculative Position Limits and Associated Rules, 63 Fed. Reg. 38525 (July 17, 1998), for an explanation of the position accountability exemptions.

hedge fund based in Greenwich, Connecticut, with over $9.2 billion under management. Although Amaranth classified itself as a diversified multi-strategy fund, the majority of its market exposure and risk was held by a single Amaranth trader in the OTC derivatives market for natural gas.

Amaranth reportedly accumulated excessively large long positions and complex spread strategies far into the future. Amaranth's speculative trading wagered that the relative relationship in the price of natural gas between summer and winter months would change as a result of shortages which might develop in the future and a limited amount of storage capacity. Because natural gas cannot be readily transported about the globe to offset local shortages, the way for example oil can be, the market for natural gas is particularly susceptible to localized supply and demand imbalances.[8] A report by the U.S. Senate Permanent Committee on Investigations affirmed that "Amaranth's massive trading distorted natural gas prices and increased price volatility."[9]

Many natural gas distributors locked in prices prior to the period Amaranth collapsed at prices that were elevated due to the accumulation of Amaranth's positions. They did so because their risk management policies require that they hedge part of their winter natural gas in the spring and summer. Accordingly, even though natural gas prices were high at that time, it would have been irresponsible (and contrary to their risk-management policies) to not hedge a portion of their winter gas in the hope that prices would eventually drop. Thus, the elevated prices which were a result of the excess speculation in the market by Amaranth and others significantly increased the cost of natural gas for many of APGA's members and ultimately for their customer rate payers.[10]

Additional concerns have been raised with respect to the size of positions related to, and the role of, passively managed long-only index funds. In this instance, APGA's concern is not whether the positions are being taken in order intentionally to drive the price higher, but rather whether the unintended effect of the cumulative size of these positions has been to push market prices higher than the fundamental supply and demand situation would justify. A similar concern arises from futures positions in natural gas that are held in connection with investment instruments traded on securities exchanges through Exchange Traded Funds or issues of Exchange Traded Notes which overlie those futures contracts.

APGA believes that the proposed rules will provide enhanced protections to the markets and that the proposed Commission-set speculative position limits are important additional tools to assure the price integrity of these important markets. Nevertheless, APGA believes that

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[8] Amaranth's strategy was reportedly based upon a presumption that hurricanes during the summer of 2006 would make natural gas more expensive in 2007, similar to the impact that hurricanes Katrina and Rita had had on prices the previous year. As reported in the press, Amaranth held open positions to buy or sell tens of billions of dollars of natural gas. As the hurricane season proceeded with very little activity, the price of natural gas declined, and Amaranth lost approximately $6 billion, most of it during a single week in September 2006. The unwinding of these excessively large positions and that of another previously failed $430 million hedge fund—MotherRock—further contributed to the extreme volatility in the price of natural gas.

[9] *See* Excessive Speculation in the Natural Gas Market, Report of the U.S. Senate Permanent Subcommittee on Investigations (June 25, 2007) ("PSI Report") at p. 119.

[10] One APGA member has quantified its loss due to this unwarranted price fluctuation as $18 million.

several modifications to the rules as proposed would enhance their effectiveness and more completely achieve the intended goals of Section 4a of the Act. APGA recommends that the Commission reconsider five aspects of the rules as proposed. These are:

1) Reduce the proposed levels of the non-spot month speculative position limits. In this regard, APGA strongly believes that the Notice proposes to set the levels so high that the speculative position limits would be largely ineffective in achieving their purpose of reducing or diminishing excessive speculation and the unwarranted price movements caused thereby.

2) Provide for an individual-month speculative position limit that is less than the all-months-combined limit.

3) Apply a single, integrated spot-month limit to all contracts on the same commodity across markets regardless of the nature of the settlement procedure. The very high level at which the limits are set is exacerbated by not applying the aggregate speculative position limit across markets in the spot-month to physically and cash-settled contracts.

4) Strengthen the position visibility rule by adopting a position accountability rule which includes authority by the Commission to order a trader over the position accountability level to refrain from further increasing the trader's position. Such conditional, "soft" limits have been used by the exchanges and could be established by the Commission within its existing authority. Moreover, such limits could be established immediately for both the futures and swaps markets and are not dependent upon further collection of data. Such conditional, soft limits would not have an adverse affect on market liquidity and would provide the Commission with an additional tool to manage market volatility.

5) Enhance the proposed large trader reporting system to collect the data necessary to address the issue of limiting the size and effect of passive, long-only traders. The Notice does not propose a means for addressing the important and significant challenges posed by passive, long-only traders. The first step in doing so is to collect and make public better data tracking of the over-all size of passive, long only traders in the markets.

With this in mind, APGA offers the following specific comments on the proposed rules.

Proposed levels are too high

The Commission itself notes that the proposed "formula would yield high position limits."[11] Indeed, when the Commission proposed the same formula in 2010, it noted that had the proposed speculative position limit levels been in effect during the years 2008 and 2009, only one trader in natural gas would have been affected.[12]

[11] *See* Notice at 4759.
[12] Statement of Steve Sherrod, Acting Director of Surveillance, http://www.cftc.gov/ucm/groups/public/@newsroom/documents/speechandtestimony/proposedrule011410_sherrod2.pdf, at 7.

The result of the Commission's own analysis points to the fact that the proposed limit levels will have no constraining effect on even the largest speculative traders in the natural gas markets. The proposed speculative position limit in natural gas in 2008-2009 would have only constrained the position of a single outlier, demonstrating that the limits as proposed will be ineffective in carrying out the Congressional mandate of Section 4a of the Act.

Given that the proposed formula-based approach to speculative position limits on its face would not yield a meaningful result in respect to the natural gas markets, the Commission should consider customary position sizes held by speculative traders as a factor in moderating the limit levels proposed by the Commission.[13] APGA's members believe that it is absolutely necessary that the Commission moderate the limits proposed if they are to have any effect whatsoever. Customary position size is a method for setting speculative position limits which has been used by the Commission in the past as an alternative to the formula-based approach of the proposed rules. The Commission has available to it large trader data through which it is possible to observe the distribution of traders in a market ranked by the size of their positions. Using this approach, it is possible for the Commission to determine the size of positions customarily held in the market and to set a speculative position limit that is effective in constraining traders that are unduly large relative to most traders in the market. Such an approach is an effective means for ensuring that the speculative position limit will not be set at a level that degrades the market's liquidity, but which is effective in curtailing excessively large speculative positions.

Provide for an individual-month speculative position limit that is less than the all-months-combined limit

The Commission has proposed a single level for both the all-months-combined level and the single month speculative position limit. This is contrary to the Commission's 2010 proposal which provided the single month limit at 2/3s the level of the all-months-combined limit. The Commission's current proposal permits speculators to hold a position 1/3 larger than it would have permitted under its 2010 proposed rules in the important next-to-expire trading month. This is a critical change, especially in light of the admitted fact that the all-months-combined limit is so large that it will affect an exceedingly few number of traders.

The next-to-expire is the most actively traded month and is used in setting prices for other contracts. Permitting a 1/3 larger position in this month would result in passive, long only traders having an even larger position in the most important trading month in the cycle. Despite the grave significance of this change from the 2010 proposal, the Commission offers no justification for permitting an increased single-month level. This is a critical shortcoming in light of the very high limits and the failure to even acknowledge the issues created by passive, long only trading.

APGA's members urge the Commission to adopt the single month limit at 2/3s the all-month-combined limit level as the Commission proposed in its 2010 speculative position limits.

Integrated limits should apply in the spot-month

[13] The Commission inquired whether this approach would be beneficial when proposing rules for speculative position limits for referenced energy contracts in 2010. *See* Question 6, 75 Fed. Reg. 4144, 4162 (Jan. 26, 2010).

The determination of whether to apply position limits consistently across all markets and participants is perhaps the single most important issue for the energy market. As we noted above, the various market segments for energy contracts are economically linked, and actions in one market segment can affect prices in the other segments. Recent events in the economically linked markets for natural gas have shown the danger of traders being able to move positions from one market to another in order to evade application of a market's position accountability rule or position limit.[14] A unified limit administered by the Commission across all markets (in addition to the limits adopted and administered by each separate market) would effectively address this issue and provide an effective and meaningful limitation on the total size of positions that a trader could amass in the delivery month.

APGA therefore strongly supports the use of spot-month speculative position limits aggregated across markets. Spot-month limits are a proven and effective tool for addressing markets with constrained deliverable supplies, which is typical of the markets for natural gas. Under the Commission's proposal, however, cash-settled contracts are permitted a separate limit. Moreover, the Commission proposes to adopt, as permitted under market rules, a conditional-spot-month limit that permits traders without a hedge exemption to acquire position levels five times the spot-month limit if the traders' positions are exclusively in cash-settled contracts.

The Commission has recognized that spot-month limits are vitally important because they apply during a concentrated period of time of "heightened potential for manipulation, corners, squeezes as well as excessive speculation."[15] However, a speculative trader with positions in cash-settled contracts could, under this proposal, qualify for a conditional-spot-month limit as permitted under exchange rules which is five times the spot-month limit. The effect of this provision is to permit a single speculator to amass a position in cash-settled contracts that is well in excess of total deliverable supplies.

Speculative position limits are a prophylactic tool to diminish and discourage manipulative and other abusive market activities. Experience tells us that there is never a shortage of individuals or interests who believe that they can, and will attempt to, affect the market or manipulate price movements to favor their market position. The significant penalties assessed by the Commission and the settlements it has accepted relating to abuse of the energy markets affirms this. However, it must be borne in mind that catching and punishing those that manipulate markets after a manipulation has occurred does not remedy the harm suffered by our members and their customers caused by manipulated natural gas prices. Thus, there should be no conditional-spot-month limit and the spot-month limit of one-quarter of the available deliverable supply should include both cash-settled contracts and physically-delivered contracts.

Position accountability in place of position visibility

The Commission has proposed a position visibility rule under its authority to require reports from large traders. However, the Commission potentially has available to it a much

[14] *See* Excessive Speculation in the Natural Gas Market, Report of the U.S. Senate Permanent Subcommittee on Investigations (June 25, 2007) ("PSI Report").
[15] *See* 75 Fed. Reg. at 4159.

stronger tool which could be implemented under its speculative position authority. This tool could be implemented immediately for both futures and swap positions. This tool, position accountability, is well tested and has been provided under existing Commission rules for many years. Under its current form, exchanges impose position accountability rules wherein a trader in order to exceed the accountability level, files a report of his position and agrees to halt further increasing his position if so directed by the exchange. These are known as "soft limits" because a trader may have a position larger than the accountability level as long as he abides by the conditions in the rule. Nothing prevents the Commission from immediately adopting a similar regime of soft limits. The target level for such a limit is not dependent upon the prior collection of data. It could be set at the level proposed for the position visibility level. Moreover, it would provide the Commission with a meaningful tool that is set lower than the "hard" speculative position limit. The soft limit generally would not be a constraint on the size of traders' positions except if the Commission invokes its authority to direct traders not to further increase positions above the accountability level due to market distortions, congestion or other aberrations.

Passive, long-only traders

The Commission has not proposed rules that would apply particular speculative position limits to passive, long-only traders. APGA notes that passive, long-only traders are a relatively new, but increasingly significant, category of trader. At least one commentator has observed that as of the middle of 2009, passive, long only traders had substantially increased their crude oil holdings over the previous year.[16]

Concerns have been raised with respect to the size of positions related to, and the role of, passively managed long-only index funds. In this instance, the concern is not whether the positions are being taken in order to intentionally drive the price higher, but rather whether the unintended effect of the cumulative size of these positions, has been to push market prices higher than the fundamental supply and demand situation would justify. Such long-only traders may trade directly in the futures markets or may affect the futures market indirectly through the long-only traders purchase of OTC swaps, the risk of which are then transferred to the futures markets. Similarly, investment instruments which overlie contracts on natural gas may also be traded on securities exchanges through Exchange Traded Funds or issues of Exchange Traded Notes.

The concerns raised with respect to these passive, long-only traders is that the additional inflows of speculative capital are creating greater demand than the market can absorb, thereby increasing buy-side pressure which results in advancing prices. As noted above, the Commission in its initial adoption of the requirement that exchanges implement speculative position limits, reasoned that

[16] Hearing on Speculative Position Limits in Energy Markets, http://www.cftc.gov/newsroom/cftcevents/2009/oeaevent072809.html (July 28, 2009) (testimony of Sean Cota (citing Moming Zhou, "As Oil Rallies, Passive Investors Increase Their Holdings," in MarketWatch, http:///wwww.marketwatch.com).

> the capacity of any contract market to absorb the establishment and liquidation of large speculative positions in an orderly manner is related to the relative size of such positions, i.e., the capacity of the market is not unlimited.[17]

APGA believes that although the Commission has not proposed a specific limit that would apply to passive, long-only investors, the issues raised by the growing presence of these traders in the markets will become increasingly significant over time. Accordingly, as a first step in answering the questions that the Commission has raised, APGA recommends that the Commission further refine its large trader reporting data and provide the market with greater transparency on the extent of passive, long only participation in the market through its Commitment of Traders Reports.

The Commission began reporting the positions of swaps dealers separately in its Commitment of Traders Reports for agricultural commodities. This has provided greater understanding of their significance to the market and has better informed the debate of exempting such entities from speculative position limits. Although the Commission is providing quarterly data with respect to passive, long only traders, providing such information on a more frequent basis with respect to energy commodities, for example as part of the Commission's Commitment of Trader's Report, would assist in shaping proposed speculative position limits rules that would apply specifically to this class of trader. Moreover, if the Commission will require additional information about the effect of such traders on the market, the Commission should at this time propose the necessary reporting requirements.

Application of limits to both cleared and non-cleared transactions

The Commission requested comment on whether speculative position limits should apply only to cleared transactions. APGA strongly supports including both cleared and non-cleared transactions under the Commission's aggregate speculative position limit. Including both cleared and non-cleared transactions is essential in ensuring that speculative position limits are effective. It would be a major and obvious loophole to set speculative position limits only with respect to cleared transactions.

Conclusion

Natural gas is a lifeblood of our economy and millions of consumers depend on natural gas every day to meet their daily needs. It is critical that the price those consumers are paying for natural gas comes about through the operation of fair and orderly markets and through appropriate market mechanisms that establish a fair and transparent marketplace. As noted above, as hedgers, public gas systems rely on speculative traders to provide liquidity and depth to the markets. Thus, APGA does not wish to see steps taken that would discourage speculators from participating in these markets using bona fide trading strategies. But more importantly, APGA's members rely upon the prices generated by the futures to accurately reflect the true value of natural gas.

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[17] Establishment of Speculative Position Limits, 45 Fed. Reg. 50938, 50940 (Oct. 16, 1981).

For these reasons, APGA supports the Commission's proposal to adopt aggregate speculative position limits on exempt commodities. APGA strongly encourages the Commission to take strong remedial action by: 1) modifying its proposal to reduce the proposed levels of the speculative position limits; 2) applying an individual month limit of 2/3s the all-months-combined limit; 3) applying a single, integrated spot-month limit to all contracts on the same commodity across markets regardless of the nature of the settlement procedure; 4) enhancing the position visibility rule into a position accountability rule; and 5) enhancing the proposed large trader reporting system as a first step in addressing the issue of limiting the size and effect of passive, long-only traders.

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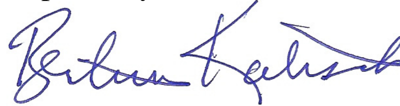
The APGA applauds the Commission's proposed speculative position limit rules and urges it to incorporate the enhancements that we have identified in this letter in the final rules in order to ensure that the Commission has the fullest panoply of tools possible.

We would be happy to discuss our comments or any of the issues raised by the proposed rules at greater length with the staff. Please feel free to contact Bert Kalisch, President and CEO of APGA, or David Schryver, Executive Vice President of APGA.

Respectfully submitted,



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