March 28, 2011

Via Electronic Submission

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

Re: Position Limits for Derivatives (RIN 3038-AD15 and 3038-AD16)

Dear Mr. Stawick:

On January 26, 2011, the Commodity Futures Trading Commission ("CFTC" or "Commission") published a notice of proposed rulemaking in the Federal Register (the "Proposed Rule") to establish federal position limits for certain physical commodity derivatives,[1] as provided under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd- Frank Act").[2] The Commission has proposed various changes to the current rules regarding exemptions from position limits for *bona fide* hedging transactions, and the aggregation of positions under common ownership or control for the purpose of applying such limits. The Gavilon Group, LLC ("Gavilon") appreciates the opportunity to provide the Commission with its comments on the proposed definition of "*bona fide* hedging transactions and positions" and the proposed aggregation rule.

I. Description of Gavilon and its Interest in the Proposed Rule

Gavilon has a broad perspective as both an end-user of various OTC and exchange-traded derivatives for hedging its commercial risk, and as a proprietary trader of such products. We believe that our perspective will help the Commission develop a definition of *bona fide* hedging that is consistent with well-established risk management practices, and a process for requesting and filing for exemptions from both the position limit and aggregation requirements that is commercially practicable for commodity market participants.

Gavilon is an active participant in the wholesale, physical commodity markets, including the markets for agricultural and energy commodities. Gavilon's agricultural operations serve farmers, livestock producers, the commercial food industry, dairy producers, feed manufacturers and industrial users. Gavilon provides origination and distribution, physical merchandising, storage, transportation, and logistics services for a variety of agricultural and fertilizer products,

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[1] Position Limits for Derivatives, 76 Fed. Reg. 4752 (Jan. 26, 2011) (to be codified at 17 C.F.R. Parts 1, 150, and 151).

[2] Pub. L. No. 111-203, 124 Stat. 1376 (2010) ("Dodd-Frank Act") (to be codified as an amendment to the Commodity Exchange Act ("CEA") in various sections of 7 U.S.C. ch. 1).

11 ConAgra Drive | Omaha, NE 68102 | P: 402.889.4000 | www.gavilon.com

including: (i) corn products, such as distillers dried grains with solubles, wet distillers grain, hominy, gluten feed and corn oil; (ii) wheat products such as wheat midds, midd pellets, red dog, wheat bran, wheat germ and second clear flour; (iii) animal products such as beef meal, pork meal, bone meal, blood meal, feather meal, edible and inedible tallow, edible lard, choice white grease and yellow grease; (iv) oilseed products such as whole cottonseed, cottonseed meal, cottonseed hulls, canola meal, soy meal and soy hulls; (v) oil products such as cottonseed oil, corn oil, palm oil, canola oil and soybean oil; and (vi) dairy products. In addition, Gavilon operates a fertilizer distribution network and provides wholesalers with a wide array of bulk fertilizer products including nitrogen-based, phosphate-based and potash-based fertilizers. Gavilon's energy operations provide physical storage and transportation services at major North American hubs for crude oil, ethanol, natural gas and natural gas liquids, and provides a range of risk management and hedging services associated with inventory positions and forward contracts.

Gavilon uses futures, swaps and other derivatives products to manage the risks that it incurs as a commercial participant in the agricultural and energy commodity markets. In certain circumstances, Gavilon currently provides its physical agricultural and energy market customers with ancillary risk management services related to their cash market business. For example, Gavilon may enter into a physical option with a natural gas customer to ensure that it will have a reliable supply of fuel during a period of time when resources may be limited. Similarly, Gavilon may enter into a physical option with a grain customer to set a "floor" on the price of a commodity to mitigate the impact of unexpectedly low prices on its customer's cash market business. These transactions, which naturally flow from and are ancillary to Gavilon's physical commodity businesses, help Gavilon's agricultural and energy market customers to manage their commercial risk in an efficient and cost-effective manner. Gavilon then uses futures and swaps to manage its exposure associated with energy transactions.

II. Summary of Comments

Gavilon respectfully requests that the Commission:

- Define what constitutes a *bona fide* hedge more broadly so that the definition encompasses existing commercial risk management practices and accommodates new risk management practices that are consistent with an applicant's commercial needs;

- Use its exemptive authority in CEA Section 4a(a)(7) to provide a process for market participants to request exemptions for non-enumerated hedging transactions;

- Employ a more streamlined process for the reporting and collection of position-related information associated with *bona fide* hedge exemptions; and

- Adopt a process that allows requests for exemptions from the aggregation requirement to become conditionally effective upon filing.

III. The Commission Should Define *Bona Fide* Hedging in a Manner that Fully Accommodates All Well-Established Risk Management Practices

CEA Section 4a(c)(2), as amended by Section 737 of the Dodd-Frank Act, provides a definition of "*bona fide* hedging transactions or positions" that closely tracks the definition in Part 1.3(z) of the CFTC's Regulations.[3] The only difference is that, unlike CFTC Rule 1.3(z), which defines a *bona fide* hedge to encompass transactions or positions that "*normally* represent a substitute for transactions to be made or positions to be taken at a later time in a physical marketing channel," the new statutory definition embodied in CEA Section 4a(c)(2) omits the word "normally.[4]" Notably, prior to the Dodd Frank Act, there was some concern that the word "normally" suggested a limitation to what could constitute a *bona fide* hedge.[5] As such, it is reasonable to conclude that Congress intended to expand, rather than limit, the definition by removing the word "normally". This also is consistent with other statements of Congress indicating that it intended to except end-users that rely on derivatives to hedge or mitigate their commercial risk from many provisions of the Act.[6] Yet, the CFTC concludes in the Proposed Rule that *bona fide* hedging transactions should be limited to five enumerated categories of "transactions or positions [that] represent cash market transactions and offset cash market risks" and should not permit any exemptions for non-enumerated cases.[7] The Commission itself acknowledges that this interpretation is at odds with prior practice, which recognized as *bona fide* hedging transactions, activity that "normally, but not necessarily," represented a substitute

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[3] Under Rule 1.3(z)(1), "bona fide hedging" means transactions or positions in commodity futures or options where: i) such transactions or positions *normally* represent a substitute for transactions to be made or positions to be taken at a later time in a physical marketing channel; ii) they are economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise; and iii) they arise from the potential change in the value of assets or liabilities or services, provided that the purpose of such transactions is "to offset price risks incidental to commercial cash or spot operations and such positions are established and liquidated in an orderly manner." 17 C.F.R. § 1.3(z)(1).

[4] CEA § 4a(c)(2); *see also* 17 C.F.R. § 1.3(z).

[5] Clarification of Certain Aspects of the Hedging Definition, 52 Fed. Reg. 27195, 27196 (Jul. 20, 1987) (observing, in order to reduce confusion, that the addition of the word "normally" to Reg. 1.3(z)(1) should not be construed in a restrictive manner).

[6] In its December 21, 2010 proposed rule further defining the terms "swap dealer" and "major swap participant," the Commission defined "hedging or mitigating commercial risk" to include any swap that:

- qualifies as a bona fide hedging transaction;
- qualifies for hedging treatment under FASB Accounting Standards Codification Topic 815; or
- is economically appropriate to the reduction of risks in the management of a commercial enterprise (*e.g.*, the swap hedges potential changes in the value of assets or liabilities).

Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant," 75 Fed. Reg. 80174, 80214-15, RIN 3038-AD06 (Dec. 21, 2010); Pub. L. No. 111-203 (2010).

[7] 76 Fed. Reg. at 4761.

for cash market transactions or positions.[8] Notably, the Commission's interpretation also is inconsistent with the plain language in Proposed Rule 151.5(a)(1) and Commission's long-standing and pragmatic policy of interpreting the exemption for *bona fide* hedge transactions in a manner intended to accommodate "the broad scope of risk-shifting transactions which may be possible in the diverse types of futures contracts now under regulation."[9]

Gavilon believes that the CFTC should not restrict commercial hedging activity beyond what Congress intended. In particular, Gavilon urges the Commission to retain the current definition of *bona fide* hedging transactions or positions in Rule 1.3(z), including the provision that allows market participants to seek an exemption for non-enumerated hedging transactions. If Congress had intended to further limit what currently is accepted as *bona fide* hedging, it could have expressly done so in the statute. The fact that it did not is a strong indication that Congress intended to preserve a robust and meaningful exemption for all types of *bona fide* hedging activity.[10] Congress closely followed the definition in current Part 1.3(z) of the Commission's regulations and further gave the Commission broad exemptive authority in Section 4a(a)(7) of the CEA.[11] We urge the Commission to continue to view the various trading strategies that currently are treated as *bona fide* hedging (along with those trading strategies that the markets develop and that assist in reducing commercial risk) as being, in the words of its General Counsel, "consistent with the objectives of the hedge exemption."[12]

A. The Commission Should Not Unnecessarily Limit the Scope of the Bona Fide Hedge Exemption

The Proposed Rule appears to limit the definition of *bona fide* hedging to five enumerated categories of activities. Contrary to the statutory definition, Proposed Rule 151.5(a)(1)(iv)(B), provides that "no transactions or positions shall be classified as *bona fide* hedging . . . unless . . . the provisions of paragraph (a)(2) [listing enumerated hedging transactions] have been satisfied," effectively eliminating the statutory exemption in CEA § 4a(c)(2) and Rule 151.5(a)(1)(i)-(iii) for non-enumerated hedges. This limitation is especially

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[8] *Id.*

[9] CEA § 4a(c)(2); 76 Fed. Reg. at 4771; Bona Fide Hedging Transactions or Positions, 42 Fed. Reg. 14832, 14833 (Mar. 16, 1977). *See also* 52 Fed. Reg. at 27196 (observing that the addition of the word "normally" to Reg. 1.3(z)(1) should not be construed in a restrictive manner).

[10] *Whitman v. American Trucking Assns.*, 531 U.S. 457, 468 ("Congress, we have held, does not alter the fundamental details of a regulatory scheme in vague or ancillary provisions – it does not, one might say, hide elephants in mouseholes."

[11] Indeed, the Commission's exemptive authority under Section 4a(a)(7), which allows the Commission to provide exemptive relief "from any requirement . . . with respect to position limits," is significantly broader than that provided under current law.

[12] Statement of Dan M. Berkovitz, General Counsel, Background on Position Limits and the Hedge Exemption, January 14, 2010, available at http://www.cftc.gov/PressRoom/SpeechesTestimony/proposedrule011410_berkovitz.html.

problematic for firms like ours that have legitimate commercial hedging needs and engage in various risk reduction strategies that may fall outside those specifically addressed in the Proposed Rule's enumerated hedging transaction clause.

Gavilon believes that the definition of "*bona fide* hedging transactions or positions" in the Proposed Rule is unnecessarily narrow and will not fully accommodate many of the important risk management practices currently used by market participants to hedge or mitigate their commercial risk. For example, the enumerated hedging transactions in the Proposed Rule do not expressly include hedges of assets that an entity anticipates acquiring or liabilities that it anticipates incurring in connection with its business. Similarly, although certain categories of enumerated hedging transactions in the Proposed Rule appear to include swaps, other categories, including the one that exempts transactions entered into to hedge "[s]ales of any underlying commodity underlying referenced contracts," appear to omit swap transactions entirely.[13] As a result, the Commission's proposed definition of "*bona fide* hedging transactions or positions" appears to conflict with the broad definition provided in the Dodd-Frank Act, which expressly encompasses swap transactions that facilitate risk reduction. Indeed, the Dodd-Frank Act requires the Commission to define such a transaction or position as one that:

> (B) reduces risks attendant to a position resulting from a swap that—
>
> > (i) was executed opposite a counterparty for which the transaction would qualify as a bona fide hedging transaction pursuant to subparagraph (A); or
> >
> > (ii) meets the requirements of subparagraph (A) [referring to non-enumerated hedging criteria].[14]

Moreover, as a practical matter, the Commission's proposed definition will interfere with existing commercial risk management practices that previously were covered by the Commission's *bona fide* hedge definition in Rule 1.3(z). We believe that the Proposed Rule would be highly disruptive to market participants who may have to reclassify certain risk management activities as non-*bona fide* hedges in order to comply with the more restrictive definition. Any benefit that may flow from this proposed definition is outweighed by the significant costs to the markets, including potentially higher energy and agricultural prices, if market participants are not able to effectively manage their price risks.

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[13] Proposed Rule 151.5(a)(2)(i), 76 Fed. Reg. 4771. Thus, the list of enumerated hedging transactions in Rule 151.5(a)(2) appears to limit the ability to hedge swaps by enumerating only the purchase, but not the sale of "referenced contracts." *Compare* proposed Rule 151.5(a)(2)(ii) (listing the *purchase* of "referenced contracts" as an Enumerated Hedging Transaction) *with* proposed Rule 151.5(a)(2)(i) (limiting Enumerated Hedging Transaction for *sales* to those of the "underlying commodity").

[14] CEA § 4a(c)(2)(B).

B. The Commission Should Use its Exemptive Authority to Adopt a Commercially Practicable Position Limits Rule that is Consistent with Congress' Intent.

CEA Section 4a(a)(7) provides the Commission with the authority to exempt any class of persons or transactions, including swaps or any class of swaps, from "any requirement it may establish . . . with respect to position limits." Unlike the provision in current Part 1.3(z)(3), the Proposed Rule provides no procedure for market participants to seek an exemption for *non*-enumerated hedging transactions. Aside from the direct impact that such a narrow definition of *bona fide* hedging could have on the ability of end users like Gavilon to engage in effective risk management, the Proposed Rule also could indirectly impede our risk management efforts by impairing the ability of institutional investors like exchange-traded funds and passive index funds to provide liquidity in the markets in which we participate.

Virtually all empirical evidence, including evidence developed by the Commission's Staff, indicates that these liquidity providers actually moderate commodity prices.[15] Before adopting rules that could significantly limit the participation of ETFs and other liquidity providers, the Commission should first complete an economic analysis demonstrating the effect that such a rule likely would have on market liquidity. Without an empirical foundation, there would be little basis to conclude that further restrictions upon *bona fide* hedging, as contemplated by the Proposed Rule, are necessary, let alone are "economically appropriate" to the reduction of risks of a commercial enterprise as the statute requires.[16] Indeed, before limiting the ability of market participants to take advantage of statutory exemptions from position limits and aggregation requirements, Gavilon believes that the Commission must demonstrate that such restrictions will not adversely affect the liquidity and price discovery function of the markets.[17] We therefore urge the Commission to exercise its exemptive authority to implement a process by which liquidity providers can obtain hedge exemptions from speculative position limits.

An overly restrictive *bona fide* hedging and aggregation regulatory regime will limit the ability of U.S. derivatives markets to maintain their competitiveness in the global marketplace. Although the Commission conditions direct access to foreign boards of trade ("FBOT") upon the FBOT's adoption of position limits that are "comparable" with those in the U.S., failure to accommodate current prudent risk management practices will force some institutional investors that are able to take their business (and even their operations) abroad, to move offshore in order to more efficiently manage their risk exposures. This will further reduce liquidity, impair price discovery, and ultimately weaken the ability of U.S. markets to serve the risk management needs of U.S. customers effectively.

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[15] *See, e.g.,* Staff Report on Commodity Swap Dealers & Index Traders with Commission Recommendations, CFTC (Sept. 2008) (finding a negative correlation between the size of investment in the market by index traders and price levels in the crude oil market).

[16] CEA § 4a(c)(2)(A)(ii).

[17] CEA §§ 4a(a)(3)(B)(iii) and (iv).

IV. The Commission Should Adopt a More Efficient and Commercially Practicable Process for Obtaining and Complying With *Bona Fide* Hedge Exemptions

Proposed Rules 151.5 and 151.10 require any market participant with a position that exceeds the applicable position limits to file with the CFTC before 9:00 a.m. on the following business day numerous items of information regarding the trader's cash market and derivative portfolios. This contrasts with the current practice of allowing traders to apply for hedge exemptions in advance of exceeding position limits. By eliminating the ability of market participants to apply for a hedge exemption in advance, the Proposed Rules will make it more difficult for market participants to plan ahead to meet their *future* hedging needs. Moreover, we believe that imposing a daily reporting requirement will be extremely burdensome for many market participants. By the Commission's own estimates, the *bona fide* hedging-related reporting requirements will result in a total burden on market participants of at least 168,000 annual labor hours at a cost of $38.6 million ($13.2 million in annual labor costs and $25.4 million in annualized capital and start-up costs).[18] Gavilon respectfully submits that the Commission has underestimated the economic and operational burdens association with the Proposed Rule and, more importantly, has not demonstrated that such costs would be justified by any corresponding benefits to the integrity, liquidity, or competitiveness of the U.S. derivatives markets.

Aside from the operational difficulties involved in assembling, synthesizing, and reporting such data on a daily basis, the requirement to apply for an exemption after, rather than in advance of, exceeding a position limit would complicate the efforts of market participants to accommodate both their short-term and long-term hedging needs. For example, the proposed requirement likely would create compliance difficulties for hedging portfolios that are dynamically adjusted to meet quickly changing market conditions. If the Commission decides not to provide an avenue for seeking an exemption prior to exceeding a position limit, Gavilon recommends that the Commission only require market participants with a position that exceeds the applicable position limits to file with the CFTC when they first exceed the position limit, and then to provide reports on a monthly, rather than daily, basis.

An initial, then monthly, reporting process would be considerably less burdensome for market participants, and would provide the CFTC with substantially the same information on exempt hedge positions. Such a reporting procedure also would be consistent with current hedge exemption procedures used by the Commission and the exchanges in Part 19 of the Commission's rules for series '04 reports, which do not require market participants to report their positions on a daily basis.

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[18] 76 Fed. Reg. at 4766.

V. The Commission Should Adopt a Reasonable Process for Requesting Exemptions from the Aggregation Requirement.

The current CEA regulations deem all positions in accounts for which any trader has a financial interest (10 percent or greater) or otherwise controls or directs trading to belong to that trader.[19] An exception, however, is provided for certain traders who have no knowledge of, or control over, the positions of its affiliates, nor direct, day-to-day supervisory authority or control over their trading decisions.[20] Significantly, this exception is self-executing subject only to a call by the CFTC for more information.[21]

Under the Proposed Rule, any entity holding accounts in which it directly or indirectly has a 10 percent or greater ownership or equity interest must aggregate the positions in such accounts.[22] The Proposed Rule provides a limited exemption from the aggregation requirement for "owned non-financial entities" that are independently controlled and managed.[23] Unlike, current requirements, however, this exception is not self-executing. Rather it would be effective only after the CFTC has approved the application.[24] Moreover, the Proposed Rule would require entities seeking an exemption from the aggregation requirement to demonstrate in a very detailed application that the owned non-financial entities are independently controlled and managed.[25]

Gavilon believes that requests for exemptions from the aggregation requirement should be effective when filed because persons and entities that file applications for such exemptions have adequate incentives to do so truthfully and in good faith due to provisions in the CEA that sanction false statements in applications filed under the Act.[26] In particular, Gavilon believes that civil and criminal liability for filing false reports with the CFTC provide a substantial deterrent to filing inaccurate exemption requests. Moreover, after the CFTC has reviewed an exemption request, it retains the authority to deny the request and to require the market participant to aggregate immediately and unwind any positions in excess of the applicable position limit in a reasonable period of time.

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[19] 17 C.F.R. § 150.4(b); *see also* CEA § 4a(a).

[20] 17 C.F.R. § 150.4(c)(2)(i-iii); Revision of Federal Speculative Position Limits and Associated Rule, 64 Fed. Reg. 24038, 24045 (May 5, 1999).

[21] 17 C.F.R. § 150.4(e).

[22] Proposed Rule 151.7(b), 76 Fed. Reg. at 4774.

[23] Proposed Rule 151.7(f), 76 Fed. Reg. at 4774.

[24] 76 Fed. Reg. at 4762.

[25] *Id.*

[26] *See* CEA § 9(a)(3).

Elsewhere in the Proposed Rule, the Commission provides for a "good faith" exemption from position limits for *bona fide* hedging transactions and for positions established prior to the effective date of Proposed Rule.[27] We believe that the same logic should apply to those who apply in good faith for an exemption from the aggregation requirement even if the Commission subsequently determines that such applicants are not eligible for such an exemption.

Failure to make exemption requests conditionally effective upon filing may substantially limit the ability of many integrated commodity market participants to operate effectively while their applications are pending because they will be required to aggregate positions during the interim. In addition, the Commission should not require market participants to make a detailed showing of independent management and control in an exemption application. Instead, the Commission should permit market participants to make a more limited showing with an obligation to supplement the application upon request.

VI. The Commission Should Define the Spot Month in a Manner that is Consistent with Current Commercial Practice

The Proposed Rule defines the spot month for each of the 28 core referenced futures contracts for which the Commission has proposed position limits.[28] In most cases, the Proposed Rule adopts the definition of spot month that is used by the exchange on which each referenced contract is currently traded. However, the Proposed Rule defines the spot month for the Kansas City Board of Trade Hard Winter Wheat contract is the period of time commencing "[a]t the close of business *three* business days prior to the first trading day in the delivery month and terminating at the end of the delivery month," whereas the Kansas City Board of Trade currently defines the spot month for this contract as commencing as of the close of business *two* business days prior to the first trading day of the delivery month.[29] Changing the definition of the spot month will be highly disruptive for market participants that rely on the Kansas City Board of Trade Hard Winter Wheat contract to manage their commercial risk. Accordingly, Gavilon requests that the Commission either define the spot month for the Kansas City Board of Trade Hard Winter Wheat contract in a manner that is consistent with the definition currently used by the exchange, or provide an explanation (with opportunity for public comment) as to why a different definition is necessary.

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[27] Proposed Rule 151.9(a), 76 Fed. Reg. at 4775.

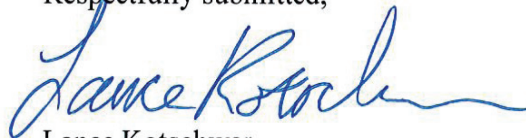
[28] 76 Fed. Reg. at 4,769-70.

[29] *Compare* 76 Fed. Reg. at 7469 with Kansas City Board of Trade Rule 2008.00(a)(1).

VII. Conclusion

Gavilon recognizes the important task that the Commission is undertaking in crafting rules to fulfill Congress's objectives with regards to "excessive speculation". We submit our comments to ensure that the Commission has the best understanding of how the financial derivatives markets for commodities operate so that it may craft its rules in a way that avoid unintended adverse effects on the markets. We believe that as the Commission adopts a new federal regime of position limits as required by the Dodd-Frank Act, it should continue to allow those who engage in legitimate hedging transactions to participate in these markets. We welcome the opportunity to discuss these issues further with the Commission and its Staff. Please contact the undersigned at 402-889-4026, if you have any questions regarding Gavilon's comments.

Respectfully submitted,



Lance Kotschwar
Senior Attorney

cc: Honorable Gary Gensler, Chairman
Honorable Michael Dunn, Commissioner
Honorable Jill E. Sommers, Commissioner
Honorable Bart Chilton, Commissioner
Honorable Scott O'Malia, Commissioner
Dan M. Berkovitz, General Counsel