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Morgan Stanley

March 28, 2011

VIA ELECTRONIC SUBMISSION

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

Re: Notice of Proposed Rulemaking Regarding Position Limits for Derivatives, (RIN 3038-AD15 and 3038-AD16)

Dear Mr. Stawick,

We are responding to the Commodity Futures Trading Commission's (the "Commission" or "CFTC") Notice of Proposed Rulemaking in which the Commission solicited comments on proposed position limits for derivatives ("Proposed Rule"), implementing statutory provisions enacted by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[1] Morgan Stanley appreciates the opportunity to provide comments on the Commission's proposed position limits, and the related proposed definition of *bona fide* hedging transaction and aggregation requirements.

Morgan Stanley supports the comments submitted in response to the Proposed Rule by the Futures Industry Association, the International Swaps and Derivatives Association, Inc., and the Securities Industry and Financial Markets Association (collectively, the "Industry Associations"). Morgan Stanley agrees with the Industry Associations that the Commission should reconsider its decision to issue the Proposed Rule, and that several specific aspects of the Proposed Rule are likely to have a significantly adverse impact on the U.S. derivatives and commodities markets. Morgan Stanley agrees, for example, that the Commission should:

- defer consideration of position limits until after it has sufficient data about the size of the relevant markets and the positions held by market participants;
- define *bona fide* hedging transactions and positions more broadly to include long-standing and important risk management transactions, and retain a mechanism by which hedgers can obtain exemptions for non-enumerated hedging transactions;

[1] Position Limits for Derivatives, 76 Fed. Reg. 4752 (Jan. 26, 2011).

- exercise its exemptive authority to establish a process by which liquidity providers can obtain exemptions from speculative position limits;
- eliminate the limitation on holding a speculative position in a spot-month physical-delivery contract while holding a proposed conditional position in a spot-month cash-settled contract of up to five times the speculative limit; and
- not condition, curtail or eliminate the availability of longstanding exemptions from the aggregation requirements based on the lack of control over trading.

In addition, Morgan Stanley believes that the Commission should reevaluate the cumulative adverse effects that the Proposed Rule and other proposed rules implementing the Dodd-Frank Act likely will have on market liquidity, price discovery, and the overall efficiency of the U.S. derivatives markets. Morgan Stanley believes that if the Commission carefully considers its authority under the CEA to set position limits and the practical implications of the Proposed Rule on market participants and their ability to effectively manage risk, it will conclude that it should withdraw the Proposed Rule.

We refer the Commission to our October 25, 2010, pre-rule proposal comment letter, and our April 26, 2010, comment letter on the Commission's prior position limit proposal, published on January 26, 2010, in which we set forth a number of examples of transactions that could be adversely affected if a position limit regime does not properly account for the potential impact the rulemaking may have on market liquidity. Some of the examples discussed include the hedging of the revenues of natural gas production, the financing of power plants and energy development projects, including wind farms and other alternative energy projects, and the purchase of distressed commodities portfolios. It is not clear that all of the transactions in these examples would qualify as bona fide hedging transactions under the Proposed Rule. Even if some these types of transactions were to qualify as bona fide hedging transactions, however, Morgan Stanley is concerned that the cumulative effect of the Proposed Rule and other proposed rules implementing the Dodd-Frank Act will impair market liquidity, price discovery and efficiencies to such a degree as to make such hedging activity costly and potentially unviable. Thus, only after it receives and reviews relevant market data should the Commission consider whether position limits are necessary and, if so, set appropriate and commercially practicable limits that preserve market liquidity and promote efficient price discovery.

I. The Proposed Rule, in Combination with Other Proposed Implementation Rules, Will Adversely Affect Market Liquidity and Disrupt Price Discovery, and May Cause Markets to Migrate Overseas.

Morgan Stanley has serious concerns about the impact that the Proposed Rule, together with several of the Commission's other proposed rules implementing the Dodd-Frank Act, will

have on the liquidity and price discovery function of the U.S. derivatives markets.[2] Accordingly, we request that the Commission consider Morgan Stanley's comments on certain aspects of the Proposed Rule together with our comments on other proposed rules, including:

- Real-Time Reporting. Reporting trades to the public in illiquid markets will potentially disclose sensitive position information and may also enable other market participants to infer the holder's identity, which, in turn, will compromise the position holder's willingness and ability to execute a hedge. Without a significant public reporting time delay, market makers will need to price transactions with end-users to reflect the increased risk of transacting in an illiquid market. This will lead to wider bid-ask spreads, less market activity, and ultimately even less market liquidity. As a result, the cost of hedging in illiquid markets likely will increase substantially.
- Swap Execution Facilities (Non-Block Trades). The proposed request-for-quote trading protocol will result in the premature disclosure of large transactions that do not meet the qualifications for block trades. This disclosure may cause the price of a swap to move significantly prior to execution. As a result, market participants responding to a request will be required to incorporate the risk of pre-trade price movements into their quotes. These costs will reduce liquidity and widen bid-ask spreads for large non-block trades, and increase transaction costs for all market participants.
- Swap Execution Facilities (Block Trades). The proposed definition of block trade is too narrow and likely will apply only to a very limited number of transactions. Moreover, even transactions that qualify as block trades will be subject to public reporting requirements after only a relatively limited time delay. As with large non-block trades, discussed above, the proposed public reporting requirements for block trades will reduce liquidity and impair market efficiency.

Morgan Stanley believes that the cumulative effect of the proposed rules, if implemented, will dramatically impair the ability of the U.S. derivatives markets to operate and compete effectively. In particular, Morgan Stanley believes that, if adopted, these rules likely will compromise the price discovery function of U.S. markets, increase transaction costs, and potentially lead to higher commodity prices for consumers. Moreover, faced with more expensive and less efficient markets, many market participants may seek risk management alternatives outside of the U.S. Accordingly, Morgan Stanley strongly urges the Commission to reconsider the probable impact of its proposed rules on the U.S. derivatives markets.

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[2] *See* Letter from Morgan Stanley dated February 7, 2011 regarding the proposed rule relating to Real-Time Public Reporting of Swap Transaction Data and Letter from Morgan Stanley dated March 2, 2011 regarding the proposed rule relating to the Core Principles and Other Requirements for Swap Execution Facilities.

II. The Commission Should Not Impose Position Limits Without Collecting and Analyzing Relevant Data.

Morgan Stanley concurs with the comments submitted by the Industry Associations and other market participants that, before it has collected and analyzed comprehensive data about the size of the relevant markets and the positions held by market participants, the Commission is not in a position to determine whether position limits are necessary to prevent excessive speculation. We are not aware of any credible, objective evidence which establishes that speculation has been the reason for an increase in commodity prices. Multiple studies, reports, and analyses, including those prepared by Commission Staff, have concluded that there is no evidence that trading by speculators has caused volatile prices in agricultural or energy markets in the last few years.[3] Moreover, as we indicated in our comments filed on April 26, 2010, the Commission already has the ability, through its large trader reporting system and Special Call authority, supported by the exchanges' position accountability rules, to conduct market surveillance that will identify potential market disruption due to excessive speculation.[4] The Commission can continue to rely on this regime to ensure that markets are open, competitive, and protected from manipulation.[5]

The Commission acknowledged in the Proposed Rule that it "does not currently have the open interest and market structure data necessary to establish non-spot-month position limits."[6] Rather than make a determination now through this Proposed Rule that hard limits on positions are necessary, Morgan Stanley recommends that the Commission wait until it collects position data later this year. Then the Commission will have the information it needs to make a reasoned decision as to whether hard position limits on any single month or all-months-combined, as well as the spot month, are necessary to prevent excessive speculation.

III. The Commission's Proposed Definition of *Bona Fide* Hedging Transaction or Position is Ambiguous and Unnecessarily Restrictive.

Morgan Stanley believes that the exemption for *bona fide* hedging transactions or positions in the Proposed Rule is ambiguous and too restrictive to enable market participants to hedge the commodity market risks that they incur in operating their businesses. As proposed, Rule 151.5(a)(1)(iv)(B) provides that, notwithstanding the broader definition of *bona fide* hedging transactions or positions in Section 737 of the Dodd-Frank Act, Rule 151.5(a)(1), and

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[3] For an extensive list of studies which conclude that speculative investments in commodities and related listed and over-the-counter derivatives have *increased* market liquidity and potentially *moderated* commodity market prices, we refer the Commission to note 14 in the FIA's March 25, 2011, comment letter on position limits.

[4] *See* Letter from Morgan Stanley dated April 26, 2010 at 17 regarding the Proposed Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations.

[5] *Id.*

[6] *See* 76 Fed. Reg. at 4753.

Regulation 1.3(z), no transactions or positions shall be classified as *bona fide* hedges unless they also satisfy the requirements for one of five categories of enumerated hedging transactions. Although the enumerated hedging transactions include some common types of hedging activity, the Proposed Rule appears to omit hedges of inventory or other assets that an entity anticipates acquiring, and liabilities or services that an entity anticipates incurring from the definition of a *bona fide* hedging transaction or position. The Proposed Rule also omits transactions used to hedge assets that an entity merchandises or anticipates merchandizing. Moreover, contrary to the language in CEA Section 4a(c)(2)(B), the Proposed Rule appears to exclude certain types of swaps, including swaps related to "[s]ales of any underlying commodity," from the definition of a *bona fide* hedging transaction or position.[7]

Morgan Stanley believes that the very narrow definition of *bona fide* hedging transactions or positions in the Proposed Rule, which is not required by the Dodd-Frank Act, would limit the ability of many market participants to hedge their commercial risk fully and effectively. As Morgan Stanley has noted in its prior comments, such a narrow definition potentially may exclude many well-established risk reducing activities, including:

- Netting Across Futures and Swaps. In order to efficiently and accurately manage risk, market participants net exposure across different categories of related futures and swaps. A definition of *bona fide* hedging that limits the ability of market participants to net their positions will artificially and unnecessarily restrict legitimate risk management activities.
- Risk Management Positions. The Commission should use its exemptive authority under Section 4a(a)(7) to permit liquidity providers, like Morgan Stanley, to hedge the risks they incur on swaps with market participants that seek to diversify their portfolios through exposure to changes in commodity prices. If the Commission does not revise the Proposed Rule, pension funds and other collective investment vehicles will not be able to use the services of experienced liquidity providers and risk managers to use commodity-related investments to adjust the exposure of their investors to other asset classes.
- Long-Term Hedges in Illiquid Markets. Developers of long-term infrastructure projects, including most new power generation and transmission projects, often rely on long-term commodity hedges to demonstrate to creditors an ability to repay their loans. Depending on the nature of the project, these hedges may be based on commodities that are not traded frequently or at delivery points that are not linked to a common derivative contract. A definition of *bona fide* hedging that does not

[7] The Proposed Rule includes several categories of purchases of referenced contracts (which include swaps), but excludes swaps from sales of similar contracts. 76 Fed. Reg. at 4771. Such transactions are expressly included in Proposed Rule 151.5(a)(1)(iv) and CEA Section 4a(c)(2)(B), but effectively excluded from the definition of *bona fide* hedging transactions or positions.

facilitate hedging long-term risk in illiquid markets will make the development of large infrastructure projects more difficult and expensive.

- Resolving Distressed Market Situations. During periods of market distress, it may be beneficial for a financially sound entity to assume the positions (and corresponding risk) of a less stable market participant. Such a transaction typically involves the transfer of a large portfolio of positions during a period of time when liquidity is low, volatility is high, and accurate valuations are difficult to obtain. The combination of a narrow definition of *bona fide* hedging and hard position limits may not accommodate such transactions and, as a result, may inadvertently compound volatility and risk at times when markets are most vulnerable.

Excluding these types of transactions from the definition of *bona fide* hedging likely will reduce liquidity and may increase systemic risk in the derivatives markets.

To avoid the potentially significant disruption that may result from a definition of *bona fide* hedging that is ambiguous or too restrictive, Morgan Stanley recommends that the Commission retain a procedure through which market participants may request exemptions for non-enumerated hedging transactions. CEA Section 4a(a)(7) provides the Commission with broad authority to exempt any class of persons or transactions from "any requirement it may establish . . . with respect to position limits."[8] Using the authority in CEA Section 4a(a)(7) to permit market participants to request exemptions for non-enumerated hedging similar to those available under current Part 1.3(z)(3) of the CFTC's regulations would provide for consistent regulatory treatment of long-standing risk management practices, and regulatory certainty for market participants. Without this consistency or certainty, creditworthy providers of important risk management services may be forced to reduce their participation in the derivatives markets, resulting in wider bid-ask spreads and, potentially, higher prices for consumers.

IV. The Commission Should Not Condition, Curtail or Eliminate the Availability of Longstanding Exemptions from the Aggregation Requirements Based On the Lack of Control Over Trading.

A. The Longstanding Exemption from Aggregation Applicable to the Separately Controlled Accounts Maintained By Futures Commission Merchants and Their Affiliates Should Remain Self-Executing.

For over three decades the Commission has permitted Futures Commission Merchants ("FCMs") and their affiliates to disaggregate positions traded independently by traders with

[8] Dodd-Frank Section 737 (to be codified as CEA Section 4a(a)(7)).

whom they are affiliated.[9] The rationale behind permitting disaggregation in such circumstances is that the correct application of speculative position limits hinges on attributing speculative positions to those actually making trading decisions for a particular account.[10] Accordingly, the availability of this exemption from aggregation has long been conditioned upon an FCM ensuring that certain indicia of independence exist between its own traders and affiliated, but independent traders. Along these lines, the exemption in Rule 150.4(d) requires an FCM to ensure that any such affiliated trader independently directs day-to-day trading decisions for the relevant account, and the exemption restricts the FCM from exercising more than the minimum degree of supervision necessary for it to fulfill any applicable supervisory obligations.

The Commission—without documenting any abuse or circumvention of the existing conditions of the exemption—has proposed to condition this exemption, in Rule 151.7(e), on its prior approval of an extensive application submitted by the FCM and annual renewal applications. The Commission states that its rationale for instituting an application and preapproval process is that "the self-executing nature of the exemptions creates an insufficient and inefficient verification regime and ultimately diminishes the Commission's ability to properly perform its market surveillance responsibilities."[11] This rationale is unpersuasive in the context of FCMs, which are subject to the extensive direct regulation and supervision by the Commission as well as their respective designated self-regulatory organizations. If the Commission wishes to obtain more detailed information regarding an FCM's ability to rely upon this exemption, a better alternative would be to request such information through calls for information, which it may currently do under Rule 150.4(e). Imposing an application and prior approval process would place unnecessary burdens upon FCMs and introduce uncertainty with respect to relief that has long served as a basic cornerstone of their business and the businesses of the integrated financial services organizations to which they typically belong.

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[9] As we explained in our April 26 and October 25, 2010, letters, Morgan Stanley, through its subsidiaries, provides risk management and investment products and services to a large, diverse group of clients and customers. In addition, Morgan Stanley, through subsidiaries such as its registered FCMs, trade commodity futures contracts for risk management and on behalf of clients. Morgan Stanley also has interests in commodity trading advisors and commodity pool operators that manage assets and provide investment management services to diverse clients, including governments, institutions, corporations, and individuals. Some of Morgan Stanley's clients use futures contracts to hedge price risks associated with assets that they own, manage, or may acquire. An inability to disaggregate separately controlled accounts of our various affiliates that trade Referenced Contracts will have a significantly adverse effect on Morgan Stanley's ability to provide risk management services to its clients and will reduce market liquidity.

[10] *See* CFTC Interpretative Letter No. 92-15, Comm. Fut. L. Rep. (CCH) ¶ 25,381 (September 15, 1992); CFTC Statement of Policy on Aggregation of Accounts and Adoption of Related Reporting Requirements, 44 Fed. Reg. 33839 (June 13, 1979).

[11] *See* 76 Fed. Reg. at 4762.

B. The Commission Should Retain The Existing Independent Account Controller and Passive Investor Exemptions.

In further recognition of the importance of attributing speculative positions to the trader controlling such positions, and to address the specific concerns of the managed futures industry, the Commission has long maintained exemptions from the aggregation requirements for independent account controllers and passive investors in commodity pools. These exemptions have enabled the establishment, management and growth of numerous accounts and pools, with the consequent increase in market liquidity. Underscoring the success of these exemptions, the Commission has gradually expanded the independent account controller exemption to permit additional categories of market participants to qualify as "eligible entities" that may rely on relief from having to aggregate futures positions they own but do not control. By permitting entities such as retirement plans to rely on such relief, the Commission has accommodated the growth of institutional participation in the futures markets, resulting in a corresponding increase in liquidity. Rescinding the independent account controller and passive investor exemptions could well shrink institutional participation in the futures markets and have an associated adverse effect on liquidity and price discovery.

In addition, the exemption from aggregation of positions available to limited partners, shareholders or similar type of pool participants who do not control the trading of the applicable pool reflects the current reality of investing in commodity pools structured as private investment funds. When investing in a private investment fund, an investor is typically not entitled to information regarding its percentage of ownership of the underlying fund or to real-time visibility into the contents of the fund's portfolio, much less control over the fund's trading. There are many practical concerns driving the maintenance of the confidentiality of this information and trading control in the context of privately offered investment funds. Due to fiduciary considerations, advisors to private investment funds may not be able to permit certain investors to view position information unless the information is made available to all of the fund's investors on an equal basis. Furthermore, it would be extraordinarily difficult to monitor and limit ownership thresholds given that an investor's stake in a fund may rise due to actions of third parties, e.g., redemptions. Therefore, instituting a new aggregation regime based on a specified percentage of ownership would be tremendously burdensome for both asset managers and investors in private investment funds.

Furthermore, many commodity pool operators frequently engage for a given commodity pool multiple commodity trading advisors who trade their positions wholly independently from one another. The advisors typically seek to protect the confidentiality of the details of their proprietary investment strategies and associated positions to prevent the crowding of trades, cloning of strategies and front-running of positions. As a result, their advisory agreements almost universally include strict confidentiality provisions relating to disclosing their positions. Thus, regardless of a commodity pool operator's ownership stake (or any other limited partner's) in a pool, the commodity pool operator is legally bound not to share information about any

commodity trading advisor's trading with the other commodity trading advisors in a multi-advisor pool (or any other limited partner), is constrained by contract not to use any such information for its other accounts or pools, and cannot exercise control over the trading of any of the independent trading advisors. The Proposed Rule would conflict with normal and customary contractual restrictions to which the parties have agreed for very sound reasons.

Eliminating the independent account controller and passive investor aggregation exemptions risks causing the following consequences, which would be counterproductive to the Commission's underlying goals:

- Increasing the Risk of Trading in Concert. The proposed aggregation rules would effectively require otherwise independent traders to share position information to comply with aggregate position limits. Encouraging independent traders to communicate regarding position information increases the risk of trading in concert.
- Decreasing Liquidity for Pool Investors. Advisors to commodity pools would likely need to impose strict limits on the percentage of equity held by each investor in order to prevent any one investor from having to aggregate the pool's positions. The need to maintain such limits could result in a decrease in liquidity for pool investors because operators may need to impose gates or restrictions on redemptions or involuntarily redeem investors in order to ensure that no one investor exceeds an applicable ownership threshold.
- Causing Disruptive Market Movements and Increasing Volatility. The application of aggregate net position limits across an integrated financial organization or a multi-advisor pool's independent trading advisors could trigger disruptive market movements and an increase in market volatility. If, for example, a trader closes out of a short position, an independent trader whose trading is aggregated with such trader may be required to rapidly liquidate a long position so that the aggregated trading entity remains in compliance with position limits. Corresponding, nearly contemporaneous liquidations of positions by unrelated traders could potentially trigger disruptive price movements and an increase in volatility.

Finally, the proposed non-financial entity aggregation exemption arbitrarily and unfairly distinguishes between financial and non-financial entities and would not provide meaningful relief for market participants. The proposal does not provide any justification for the Commission's exclusion of financial entities. A financial entity should be able to qualify for an exemption from aggregation under the same conditions as a non-financial entity. If the Commission is concerned that information barriers that have been established between commonly owned financial organizations are insufficient for maintaining true trading independence among the organizations' traders, a more measured and appropriate response than arbitrarily excluding financial entities would be to audit such organizations for the adequacy of their information barrier policies and procedures.

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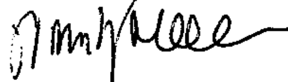
We appreciate the opportunity to comment to the CFTC on the Proposed Rule and would be pleased to discuss any questions the CFTC may have with respect to this letter. Any questions about this letter may be directed to William F. McCoy, Managing Director and Counsel, at 914-225-5540.

Respectfully submitted,



Simon T.W. Greenshields
Managing Director
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