March 28, 2011

Via Online Submission

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

Re: COMMENTS OF THE UTILITY GROUP - Position Limits for Derivatives - **RIN Nos. 3038-AD15, 3038-AD16**

Dear Mr. Stawick:

On January 26, 2011, the Commodity Futures Trading Commission ("CFTC" or the "Commission") published a notice of proposed rulemaking entitled "Position Limits For Derivatives" ("Position Limits NOPR" or "NOPR").[1] The Position Limits NOPR proposes to establish position limits for "economically equivalent derivatives" consisting of futures, options, and swaps relating to specified referenced contracts.[2] The position limits will consist of (1) aggregate position limits for spot months; and (2) aggregate, futures class, and swaps class position limits for single month and all months combined positions.[3] The proposed position limits would be in addition to current exchanged-based limits.

Before the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act,[4] the Commission had proposed federal position limits for certain commodity futures and options.[5] Subsequent to Dodd-Frank's enactment, the Commission withdrew that rulemaking[6] and, in accordance with Section 737 of Dodd-Frank, proposed the Position Limits NOPR.

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

[2] NOPR at 4753.

[3] *Id*. at 4752.

[4] Public Law No. 111-203, 124 Stat. 1376 (2010) ("Dodd-Frank").

[5] Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations, 75 Fed. Reg. 4144 (Jan. 26, 2010) ("2010 Proposal").

[6] Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations, 75 Fed. Reg. 50950 (Aug. 18, 2010).

I. Introduction

The members of the Utility Group[7] are large investor-owned electric companies. Utility Group members are end-users and all are physical energy companies with generation, transmission, and distribution components to their businesses. They hedge the commercial price volatility risk of their physical businesses using swaps, futures, and forward cash market transactions. The Utility Group members are also members of the Edison Electric Institute (EEI) and support EEI's comments on the NOPR ("EEI Comments").

The Utility Group members' current derivative-based hedging is largely made up of Over-the-Counter ("OTC") swaps. As such, although position limits have been applicable to exchange-traded futures and Significant Price Discovery Contract ("SPDC") hedges, tracking such positions and keeping within exchange position limits has not been a burdensome exercise. The Utility Group, however, believes that the NOPR, which would require parties to comply with a significant array of requirements and obligations, would result in an enormous, new regulatory burden that is not justified by any benefit or policy goal contemplated in Dodd-Frank. As the Utility Group's comments will explain, compliance with the proposed rules will not only be extremely difficult to implement, but in some cases it will not even be possible to comply with the rules as written.

The Utility Group respectfully submits that the compliance burden of the Commission's proposal is not justified by any demonstrable benefits. The members of the Utility Group have been in the physical commodity business since the early 1900s and do not believe the business has been plagued by excessive speculation which would warrant such a complex and pervasive rule as that proposed by the NOPR.

The NOPR requires traders to track and comply in real-time with no fewer than six different types of position limits as well as visibility limits (which are set at a lower threshold). Further, the swaps that are to be included in the set of derivatives making up a position are poorly defined and ambiguous. Upon exceeding a position limit or position visibility threshold, traders will be required to file, on a daily basis, specified forms and "certifications" which, as of this time, are undeveloped and only vaguely described.

The burden of compliance with the NOPR is not justified by the achievement of any important policy goal. Dodd-Frank provides that the Commission should consider the appropriateness of position limits. Position Limits are only appropriate if there is an empirical basis to show that excessive speculation has harmed markets and that the proposed regime will remedy that harm. The Commission has presented no facts that support a conclusion that excessive speculation has or will occur or that its proposal will impact such excessive speculation. Therefore, the Commission should exercise the authority the statute gives it and withdraw its Position Limits NOPR.

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[7] The Utility Group is comprised of American Electric Power, Edison International, Exelon Corporation, and Southern Company.

II. Dodd-Frank Does Not Require the Issuance of a Position Limits Rule

Although Dodd-Frank requires the Commission to issue numerous rules to implement the statute and effectuate the regulation and oversight of OTC swaps, it does not require the promulgation of a position limits rule. Rather, such a rule need be issued only if it is appropriate to do so. As further explained herein, the rulemaking is not appropriate.

Section 737 of Dodd-Frank states:

"(A) IN GENERAL.—In accordance with the standards set forth in paragraph (1) of this subsection and consistent with the good faith exception cited in subsection (b)(2), with respect to physical commodities other than excluded commodities as defined by the Commission, the Commission shall by rule, regulation, or order establish limits on the amount of positions, *as appropriate*, other than *bona fide* hedge positions, that may be held by any person with respect to contracts of sale for future delivery or with respect to options on the contracts or commodities traded on or subject to the rules of a designated contract market.

"(B) TIMING.—

"(i) EXEMPT COMMODITIES.—For exempt commodities, the limits required under subparagraph (A) shall be established within 180 days after the date of the enactment of this paragraph.[8]

As can be seen from the foregoing, the Commission is required by Dodd-Frank only to establish position limits "as appropriate." The deadline of 180 days after enactment in clause (B)(i) for exempt commodities[9] is directly tied to a determination that such limits are appropriate.

As it is designed to overhaul the existing regulatory regime, Dodd-Frank is replete with directives to the Commission that it "shall" conduct rulemakings and issue rules.[10] In the case of position limits, Congress unambiguously modified the word "shall" with the requirement that limits only be established "as appropriate." If position limits were mandated similar to the other rules required by Dodd-Frank, the words "as appropriate" would be superfluous. It is a maxim of statutory interpretation that the words of a statute should be given a construction that assumes they were chosen to provide meaning and substance.[11] In this case, that means the Commission

[8] Dodd-Frank § 737(a)(4) (as codified at 7 U.S.C. § 6a(a)(2)) (emphasis added).

[9] Energy commodities generally fall within the Commodity Exchange Act ("CEA") definition of "Exempt Commodities." See 7 U.S.C. § 1a(14) (2011).

[10] *See*, *e.g.*, Dodd-Frank § 723(a)(3) (as codified at 7 U.S.C. § 2(h)(2)(A)(i)) ("The Commission on an ongoing basis shall review each swap . . . to make a determination as to whether the swap . . . should be required to be cleared."); *id.* (as codified at 7 U.S.C. § 2(h)(5)) ("Rules adopted by the Commission under this section shall provide for the reporting of data . . . ."); *id.* at § 729 (as codified at 7 U.S.C. § 6o-1(a)(2)(B)) ("The Commission shall promulgate an interim final rule within 90 days of the date of enactment of this section providing for the reporting of each swap entered into before the date of enactment . . . .").

[11] *TRW Inc. v. Andrews*, 534 U.S. 19, 31 (2001) (one must give effect to each word in a statute so that none is rendered superfluous).

must find it appropriate to issue such rules based upon the substantial evidence that must underlie a discretionary rulemaking.[12]

Given that the Commission has the discretion to determine whether position limits are appropriate, it must, in light of the plain words of the statute, consider whether there is any empirical evidence that "excessive speculation" in specific commodity derivative products has created an "undue and unnecessary burden on interstate commerce."[13] If the Commission affirmatively determines that it has, it should ensure that the proposed rule would mitigate such a burden, as well as "not cause price discovery to shift to trading on foreign boards of trade."[14] Moreover, the Commission has not defined or even described what constitutes "excessive speculation." Defining a term so crucial to the entire rulemaking is necessary to allow appropriate review and reasoned decision-making.

III. The Position Limits NOPR Targets Concentration, Not Speculation

The NOPR is designed to prevent a trader from holding speculative positions above the specified limit for trades that do not merit a *bona fide* hedge exemption. But the NOPR conflates the concept of excessive speculation with the size of positions of particular traders and makes no effort to identify and remedy the existence of "excessive speculation" in the market. As explained further below, the impact of excessive speculation on the market, if there is one, stems from the existence of speculation in the market as a whole. That is, excessive speculation does not relate to the activity of a single trader whose position may exceed a position limit, but whose position may still be irrelevant to the circumstances and forces that may be driving the overall market.

"Excessive speculation" that could theoretically impact a market could clearly occur without any violations of the proposed position limits. Assuming that traders independently desired to take directionally similar speculative positions at levels below position limits, uncoordinated acquisition of such speculative positions by many market participants could easily yield the rapidly rising market prices that constitute "excessive" speculation. While the Utility Group is not suggesting that this kind of "group think" warrants regulatory intervention, it is clear that the rules proposed in the NOPR would do nothing that could limit or affect this phenomenon.

Such directional speculation is not only an academic construct. In the period between mid-2007 and the third quarter of 2008, investors concerned about equity and bond market valuations were looking for another "asset class" in which to invest. Many investors took the view that global market dynamics, driven by developing economies such as China and India, would push up commodity prices as demand for energy and agricultural products increased. As such, they looked to invest in the "commodity asset class." This group of investors, which included the

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[12] *See*, *e.g.*, *Nat'l Fuel Gas Supply Corp. v. FERC*, 468 F.3d 831, 843-44 (D.C. Cir. 2006) (overturning agency rulemaking because it was not based on sufficient evidence to justify the new rules and noting that "professing that an order ameliorates a real industry problem but then citing no evidence demonstrating that there is in fact an industry problem is not" the reasoned decision-making required of an agency).

[13] NOPR at 4754 (citing 7 U.S.C. § 6a(a)(1)).

[14] Dodd-Frank at § 737(a)(4) (as codified at 7 U.S.C. § 6a(a)(2)(C)).

kind of entities not normally thought of as speculators (e.g., pension funds and other large institutional investors), did not typically acquire unusually large positions in commodities. They did, however, collectively and speculatively invest in the same directional manner by "going long commodities." Without expressing an opinion as to whether this speculative investment was "excessive," the Utility Group notes that the recent interest in the commodity asset class did not necessarily involve individual traders holding large concentrations.

As such, the Position Limits NOPR does not focus on the effects of speculation *on the market.* Instead, it is designed to limit individual trader positions. The Utility Group understands that individual traders make up the market, and their positions may require scrutiny to prevent market manipulation. However, "excessive speculation" is not market manipulation. Accordingly, if the Commission determines to move ahead with a position limits rule, it must explain how its proposed regime is meaningfully associated with the prevention of harmful "excessive speculation" in the market. The Utility Group believes this is not possible for the reasons articulated above, but the Commission has a legal obligation to explain its views and to provide market participants an opportunity to comment on the merits of those views.

IV. The Commission Should Withdraw the Position Limits NOPR Because There Is No Empirical Support Provided For It

The Commission provides no empirical basis in the Position Limits NOPR to justify its conclusion that excessive speculation has burdened or harmed modern markets in any way. To the degree the NOPR relies upon any real-world events, they date from the 1920s or 1970s and do not relate to speculation.[15] As set forth above, the NOPR conflates concentration with speculation and does not contain any empirical data or studies that justify that association. In fact, the NOPR's silence is in contrast to the Commission's recent studies described below that conclude there is no link between concentration and speculation that can result in deleterious market impacts.

In the wake of recent energy and agricultural commodity price volatility, the CFTC, together with other agencies, investigated the associated impact of speculation. They concluded:

> If a group of market participants has systematically driven prices, detailed daily position data should show that that group's position changes preceded price changes. The Task Force's preliminary analysis, based on the evidence available to date, suggests that changes in futures market participation by speculators have not systematically preceded price changes. On the contrary, most speculative traders typically alter their positions following price changes, suggesting that they are responding to new information – just as one would expect in an efficiently operating market.[16]

The Commission should base its rules on substantial evidence that properly supports its conclusions, and the Commission must present such evidence, as well as acknowledge its

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[15] *See*, *e.g.*, NOPR at 4754.

[16] Interagency Task Force on Commodity Markets, *Interim Report on Crude Oil*, p. 3 (July 2008). This conclusion was re-affirmed in the unpublished final report.

previous conclusions on this subject and explain or refute them before implementing any rule designed to prevent excessive speculation. This is the only way that the Commission could find that its proposed limits are "appropriate," as the statute requires.

The Utility Group understands that while the Commission has significant expertise and experience in exchange-traded futures and options, its familiarity with OTC swaps markets is not as extensive. The Commission will only be able to develop such expertise through an examination of the data flow resulting from the implementation of Dodd-Frank. That examination will enable the Commission to gain a full understanding of the scope and dynamics of swap markets. In addition, the implementation of Dodd-Frank itself will unquestionably impact market dynamics. Given the need for an empirical basis that confirms the existence of excessive speculation and indicates how it could be prevented, it is premature for the Commission to issue a position limits rule for swaps. Simply stated, the Commission has no data, and cannot currently obtain any data, upon which to base or justify its proposal.

In addition, the Utility Group contends that it would be imprudent to proceed with the proposed rules without this kind of thorough review and analysis because the rules themselves would impose a massive new burden to enable compliance. It would be wasteful and costly to society to mandate such a burden without substantial certainty regarding the effectiveness of the proposed rules to achieve the statute's stated purpose to curb excessive speculation. Only a clearly articulated explanation of the link between the proposed position limits and the avoidance of speculation, and compelling reasons supported by solid market data justifying why the Commission should attempt to curb excessive speculation, could justify the imposition of such a burden.

V. The Compliance Burden Imposed By the Position Limits NOPR Is Excessive

Today, traders must track their compliance with exchange-based position limits in the spot period before contract expiry. They also must understand and be aware of their positions with regard to exchange-based accountability levels. As stated above, because Utility Group members frequently hedge with OTC swaps, compliance with exchange limits has not been burdensome.

However, the rules in the Position Limits NOPR would materially change the *status quo*. In addition to the exchange-based positions limits, members would be required to track their aggregate positions on all exchanges together with all of their OTC "economically equivalent" swaps. At the outset, these positions would have to be tracked for the spot month and later for each month and all months by class and in aggregate. Tracking will also be required to support required certifications for special conditional spot-month limits.[17] As compliance with position limits is a real-time obligation, this effort would be required in real-time and for every day of the year.

Currently, traders can track the discrete positions held by their firm on a single exchange (particularly in the spot period) and ensure that they do not exceed position limits. This requires a monthly focus for only the seventy-two hour period in which the exchange-based current

[17] NOPR at 4765.

position limits attach. Under the NOPR, in addition to the current tracking process, traders would have to: 1) determine whether each OTC swap would count and then convert such swaps to futures equivalents; 2) track the resulting data and combine those positions with exchange-traded swaps and futures/options; 3) separate swaps and futures/options; and 4) do all of the above for the spot month, every single month, forward month, and all months. Further, as position limits would apply in real-time, traders would have to do all of the foregoing on a real-time basis.

In addition, the complexity of the compliance requirements is exacerbated by the expansion in scope of the products to be tracked and included in a "position." As opposed to the current exchange-based position limits regime, this expansion would mean that Utility Group members may have several traders trading products that make up a limited position. Currently, there may be discrete traders trading futures and others trading swaps. As proposed in the NOPR, all traders and positions in "economically equivalent" products would have to be combined and a real-time compliance requirement followed. The existing compliance information, technology, and human resources assets employed by Utility Group members, even though they are among the largest utility companies in the United States, simply do not come close to enabling compliance with these proposed obligations. Compliance with the Position Limits NOPR, if it can be achieved, would require an extraordinary amount of expenditure and new resource commitments.

Given the lack of empirical supporting data for the proposed rules, the complexity and expense related to compliance with this NOPR, together with the significant costs of compliance with the many other requirements of Dodd-Frank that the Commission must implement, the Utility Group recommends that the Commission withdraw the NOPR and not issue a position limits rule.

VI. It Is Unclear Which Swaps Would be Included in the Proposed Position Limits

As proposed in the NOPR, "Referenced Contracts" are to be subject to position limits.[18] The scope of the contracts to be included, although vague, is clearly extraordinarily broad. The Utility Group requests that if the Commission determines to go forward with the rules proposed in the NOPR, it clarify and significantly limit the scope of "economically equivalent" swaps captured by the rules.

The definition proposed by the Commission is as follows:

> *Referenced contract* means, on a futures equivalent basis with respect to a particular core referenced futures contract, a futures listed in § 151.2, or a referenced paired futures contract, option contract, swap or swaption, other than a basis contract or contract on a commodity index.
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> *Referenced paired futures contract, option contract, swap or swaption* means, respectively, an open futures contract, option contract, swap or swaption that is:

[18] *Id.* at 4753.

> (1) Directly or indirectly linked, including being partially or fully settled on, or priced at a differential to, the price of any core referenced futures contract; or
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> (2) Directly or indirectly linked, including being partially or fully settled on, or priced at a differential to, the price of the same commodity for delivery at the same location, or at locations with substantially the same supply and demand fundamentals, as that of any core referenced futures contract.[19]

As proposed, more than just economically equivalent swaps would be captured and combined with other contracts to form a position subject to limits. OTC swaps can take the form of an economically equivalent contract to a core referenced contract. That is, a form that mimics a core referenced futures contract. The economic substance of the mimic contract (a "look alike") is identical to the core referenced contract. In other words, it is truly equivalent to the referenced exchanged-traded futures contract.

OTC swaps, however, can also use a core referenced contract as a component of a floating price calculation without being in any way economically equivalent to a core referenced contract. For example, power markets often transact "virtual tolling" swaps. Rather than mimic a core referenced contract, such a swap uses the contract as an input into a formula that mimics the output of a power plant. The core referenced contract will be part of a fuel costs construct that, together with plant efficiency components (heat rate) and other electric market factors, ultimately results in a floating price expressed in dollars per megawatt hour. Other swaps reference core referenced contacts with basis differentials, use different notional quantities or time periods, or otherwise contain significant changes to basic economic aspects of a core referenced contract. In contrast to a look alike contract, these contracts are not economic equivalents of core referenced contracts. As proposed, it appears that the Commission is planning to subject any and all contracts that reference the core referenced contract in any way, regardless of economic substance, to a single position limit. In addition, the Commission is also proposing to include all contracts with "the same supply and demand fundamentals . . . as that of any core referenced futures contract" to the limits for such a contract, which would mean even further unnecessary broadening of the “position” subject to a limit.[20]

The Commission should restrict any limits it produces to "look alikes." Any other approach would include contracts that are not the economic equivalent of the core referenced contract. There is no basis upon which to impose limits to contracts with a limited connection to the particular referenced contract or those "with substantially the same supply and demand fundamentals."

Further, if the Commission expands the universe of affected contracts beyond look alikes, the resulting ambiguity would create a circumstance where each trader will be determining the qualification of swaps for the limits' applicability in its own judgment. The NOPR provides no clarity as to what "substantially the same supply and demand fundamentals" means in this

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[19] *Id.* at 4768.

[20] *Id.* at 4768.

context or how a trader is supposed to determine if its swap is covered. Similarly, the NOPR does not offer any clarity on when an indirectly linked swap would cease to be covered, if ever, or how a trader could tell when this occurs.

In addition, the Commission has also stated in the NOPR the following:

> Federal spot-month limits would apply only to futures, options and swaps that are directly price-linked to a 151.2-listed core referenced contract or that settle to a price series that prices the same commodity at the same delivery location.[21]

Thus, apparently for the spot month limits, traders will need to track a different set of contracts. The Utility Group recognizes that this is more limited. However, the definition is still unclear as to whether referenced contracts in this context are limited to look alikes. In addition, the above-referenced language is not found in the regulatory text proposed by the Commission. Unless it is included in the actual regulation, such preamble language could not apply.[22]

Therefore, the Utility Group believes that the significant issues surrounding the difficulty of integrating different kinds of swaps into the already complex proposed position limits structure is yet another reason for the Commission to decline to issue a rule at this time. If the Commission determines it will move forward with a rule, it must limit "economically equivalent" swaps to those that are actually economically equivalent, *e.g.* look alikes, and clarify the regulatory text to reflect the delivery location requirements set forth in the preamble.

VII. The Concept of a Risk Management Exemption Should Be Included in the Position Limits NOPR

In the 2010 Proposal, the Commission proposed a "Risk Management Exemption" to permit hedging of financial risk.[23] In the NOPR, the Commission provided for a "pass through" of a *bona fide* hedge exemption instead of an exemption for providing a hedge in the normal course.

As proposed in the NOPR:

> *Positions that are maintained.* For a swap that satisfies the requirements of paragraph (a) of this section, the party to whom the cash market commodity risk is transferred may itself establish, lift and re-establish a position in excess of the position limits of § 151.4 *provided that: (1) The party and its counterparty comply with the requirements of paragraphs (g) through (i) of this section*; and (2) The party may only exceed such position limit to the extent and in such

[21] *Id.* at 4757.

[22] *See Nat'l Wildlife Fed'n v. E.P.A.*, 286 F.3d 554, 570 (D.C. Cir. 2002), *supplemented sub nom. In re Kagan*, 351 F.3d 1157 (D.C. Cir. 2003) ("[I]t is the language of the regulatory text, and not the preamble, that controls.").

[23] 2010 Proposal at 4163.

> amounts that the qualifying swap directly offsets, and continues to offset, the cash market commodity risk of a *bona fide* hedging counterparty.[24]

Thus, the Commission has proposed to permit a person providing a hedge to rely upon a hedge exemption "passed though" to it by its hedging counterparty. As proposed in paragraphs (g) though (i) of proposed Section 151.5, "at least one party" would be "relying on a *bona fide* hedge exemption"[25] and the party with "cash market commodity risk relying on a *bona fide* hedging exemption" timely files a Form 404S.[26] Accordingly, unless the hedging party is relying on a *bona fide* hedge exemption, the Position Limits NOPR would bar the pass through of an exemption to a counterparty providing a hedge. As proposed, the hedge exemption only applies where a trader is over the limit, and not to all hedges.

The Commission must revise the proposal in the Position Limits NOPR to provide that entities, such as swap dealers, can offer hedges to end-users without having to manage the number of hedges of their counterparties. An entity that facilitates and makes important markets used by hedgers must be able to participate in that market without having to manage such limits. A contrary outcome would be completely at odds with the intent of Dodd-Frank. Dodd-Frank is intended to prevent systemic risk by regulating swap dealers in many other ways. It is not intended to severely hamper the ability of such entities to make markets that are vital to the financial viability and sustainability of end-users who seek to obtain hedges from them.

VIII. The Position Limits NOPR Requires Burdensome Filings of Forms That The CFTC Has Not Developed or Shared With The Public

The Commission has proposed the use of Forms 401,[27] 402S,[28] 404,[29] 404A,[30] and 404S,[31] with filings required as frequently as on a daily basis for both position limits[32] and position

[24] NOPR at 4773 (proposed § 151.5(j)) (emphasis added).

[25] *Id.* (proposed § 151.5(g)).

[26] *Id.* (proposed § 151.5(i)).

[27] *Id.* at 4773, 4775 (proposed § 151.6(b); proposed § 151.9(b)(3)).

[28] *Id.* (proposed § 151.6(c); proposed § 151.9(b)(3)).

[29] *Id.* at 4771-4775 (proposed §§ 151.5(b), (f); proposed § 151.6(d); proposed § 151.9(b)).

[30] *Id.* (proposed §§ 151.5(c), (f); proposed § 151.6(d); proposed § 151.9(b)).

[31] *Id.* (proposed §§ 151.5(d), (f), (i); proposed § 151.9(b)).

[32] As proposed by the Commission, a trader seeking an anticipatory hedge exemption must file a Form 404A at least ten days in advance of the date it expects to hold a position in excess of position limits. Another Form 404A must be filed by the trader ten days in advance of a change in the applicable positions in addition to and aside from anticipatory hedge exemptions. Forms 404 and 404S must be filed for every day a trader actually exceeds position limits pursuant to transactions that qualify for such exemptions regardless of the existence of an anticipatory hedge exemption. Form 404S must also be filed for each day the hedge exemption is relied upon by a counterparty. Each of Forms 404, 404S, and 404A, as each may be applicable, must also be filed where a position limit is exceeded pursuant to a *bona fide* hedge exemption in the hedging of commercial activity or positions resulting from swaps that are used for the hedging of commercial activity that "does not involve the same quantity or commodity as the quantity or commodity associated with positions in referenced contracts that are used to hedge." These forms must

visibility.[33] In addition to these forms, a "certification" must also be filed by a trader to confirm that it has met the standards for the "special conditional spot-month limit."[34]

The Utility Group members are all significantly regulated and are quite familiar with the rulemaking process. Based on the Utility Group's experience in rulemakings, when state and federal administrative agencies are proposing rules that rely on the filing of data collection forms, the rulemaking process also provides for comments on the proposed forms. Although the Commission has provided a high level list of the data that is expected to be required on the forms, no specimens have been provided for comment.

The Utility Group believes it is critical that the Commission notice the forms and receive comment on them. It is only through this process that market participants and the Commission can determine if these forms are workable, clear, and not excessively burdensome to complete. Without the opportunity to revise the forms upon the receipt of comments, the Commission will likely create a chaotic process where traders will see the forms for the first time in a final rule (once they have been "set in stone") and therefore would be forced to do the best they can to comply with them without any real confidence that the Commission would consider them compliant. Such an outcome will result in needless problems for both the Commission and traders.

Given the core nature of the proposed forms to the regulatory scheme contemplated by the NOPR, unless traders have the ability to review and comment on the forms, they will not be provided the required notice and opportunity to comment on significant aspects of its requirements. The Commission must issue proposed Forms 401, 402S, 404, 404A, and 404S for notice and comment before taking any further action towards a position limits rule.

Under the Administrative Procedure Act ("APA"),[35] although an agency need not publish in advance every precise proposal it may ultimately promulgate as a rule,[36] interested parties must

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be filed on the day after the limit is exceeded and the first day after the position is below the limit. Similarly, the certification must be filed as required by Section 151.10, which appears to require the filing by 9 a.m. on the business day after the need to comply with the "special conditional spot-month limit" occurs. It is unclear how frequently thereafter, if at all, the certification need be filed. *See id.* at 4772, 4775 (proposed §§ 151.5, 151.10).

[33] Traders are obligated to file Forms 404, 404A, and 401 or 402S (as applicable), when position visibility limits are exceeded. A Form 401 must be filed for each position in referenced contracts in the same commodity that reaches or exceeds a visibility level; separately, a Form 402S must be filed for each position in referenced contracts in the same commodity that reaches or exceeds a visibility level for any uncleared swap position based on substantially the same commodity as that which underlies the referenced contract. These filings are required to be made by the later of 9 a.m. five business days after the time the applicable visibility level is reached or exceeded or 9 a.m. on the first business day of the subsequent calendar month. Forms 404 and 404A must also be filed within the same timeline for any applicable positions exceeding visibility levels. *See id.* at 4773, 4775 (proposed §§ 151.1(b)(3), 151.6).

[34] *Id.* at 4765.

[35] 5 U.S.C. § 553(b)(3) (2006).

[36] *See, e.g.*, *Cal. Citizens Band Ass'n v. United States*, 375 F.2d 43, 48 (9th Cir. 1967).

be afforded a reasonable and meaningful opportunity to participate.[37] Courts have overturned administrative regulations on the grounds of inadequate notice where the agency's general notice of the "subjects and issues" was not sufficient to advise groups vitally affected by the details of the rule to comment on those details.[38] The D.C. Circuit rejected the Environmental Protection Agency's ("EPA") adoption of a computer model because in the notice issued before its adoption, EPA did not reference the model in its summary and suggested "more malleability and vagueness" than actually characterized the model. Finding that adoption of the model constituted a rule, the Court stated that "[a]n agency may not introduce a proposed rule in this crabwise fashion."[39]

Beyond the Utility Group's concerns with the lack of proposed forms, the compliance burden of the NOPR is further compounded by the requirement of the daily filing of such forms. It is the Utility Group's position that there should be no daily filings. Instead, the Commission should implement monthly filings with a "look back" which could track daily levels. A reasonable period for such "look back" reporting would be within ten days after the end of the relevant month.

The Commission will be receiving a significant flow of data under Dodd-Frank, including data concerning these positions. The Commission should focus on efficient data flow and work to avoid inefficient filings that will only burden both the Commission and traders without creating any offsetting benefit.

IX. *Bona Fide* Hedges Must Include All Transactions Which Hedge or Mitigate Commercial Risk

In the Position Limits NOPR, the Commission has listed certain Enumerated Hedging Transactions as meriting a *bona fide* hedge exemption.[40] The Commission's proposal is ambiguous as to whether the list is exclusive since the proposed regulation states that the definition of a *bona fide* hedging transaction "*includes*" the listed transactions.[41]

The end-user exception included in Dodd-Frank permits hedgers that are, *inter alia*, entering into transactions for the purpose of hedging or mitigating commercial risk to elect to opt out of clearing.[42] As noted in the Utility Group's comments to the Commission's Notice of Proposed Rulemaking regarding the further definition of certain entity-related terms under Dodd-Frank, the Commission has proposed a workable and broad definition of the term "hedging or mitigating commercial risk."[43]

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[37] *See e.g.*, *Forester v. Consumer Prod. Safety Comm'n*, 559 F.2d 774, 787 (D.C. Cir. 1977).

[38] *See, e.g., Wagner Elec. Corp. v. Volpe*, 466 F.2d 1013, 1019 (3rd Cir. 1972) ("The absence of comment from such groups may well be because the notice of proposed rulemaking never advised of this subject or issue.").

[39] *McLouth Steel Prods. Corp. v. Thomas*, 838 F.2d 1317, 1322-23 (1988).

[40] NOPR at 4771 (proposed § 151.5(a)(2)).

[41] *Id.* (emphasis added).

[42] Dodd-Frank § 723 (as codified at 7 U.S.C. § 2(h)(7)(A)); *see also* 75 Fed. Reg. 80747 at 80748.

[43] *See* Comments of the Utility Group, Further Definition of "Swap Dealer," "Security-Based

If the Commission issues a final position limits rule, it must make clear that the regulatory text discussing "Enumerated Hedging Transactions" is non-exclusive. Further, it should clarify that any transaction that meets the test of hedging or mitigating commercial risk for the purpose of the end-user exception to clearing also qualifies as a *bona fide* hedge transaction. If the Commission is to move forward with a position limits rule, it must do so in a manner that is logical and consistent with its overall implementation of Dodd-Frank.

X. The Hedge Exemption and Position Visibility Process Should Be Revised

As explained herein and set forth above, the requirements imposed on traders to comply with the NOPR are extremely burdensome. Even after undertaking the effort needed to put processes in place to comply, it is unlikely that traders would be able to always perfectly track their positions in real-time due to the complexity and ambiguity in the proposal.

As proposed by the Commission, a trader is generically granted an exemption to position limits for its *bona fide* hedging transactions as long as it files a Form 404 by 9 a.m. the day after exceeding the position limit.[44] A trader can also obtain an anticipatory hedge exemption, which must be approved by the Commission by filing a Form 404A at least ten days before exceeding a limit.[45] Supplemental reports are also required if the anticipated requirements or production set forth in the Form 404A change.[46] If a trader exceeds the position limits and has an anticipatory hedge exemption, it still must file a Form 404 by 9 a.m. the day after exceeding the position limit.[47]

In addition to filing the forms, traders that "qualify for *bona fide* hedge exemptions" must also "maintain complete books and records concerning all of their related cash, futures, and swap positions and transactions and make such books and records, along with a list of swap counterparties, available to the Commission upon request."[48]

Further, traders are also subject to position visibility rules, which differ from position limits by only triggering informational filings.[49] The filings not only include data on a trader's holdings, but also certifications concerning uncleared swaps and cash positions.[50]

With respect to the proposed visibility rules, given the significant overall burden of Dodd-Frank implementation and the enormous burden of the proposed rules for position limits as such, the

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Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant", February 22, 2011.

[44] NOPR at 4775 (proposed § 151.10(b)(3)).

[45] *Id.* at 4765 (proposed at § 151.5(c)(1)).

[46] *Id.* at 4766 (proposed at § 151.5(c)(3)).

[47] *Id.* at 4775 (proposed § 151.10(b)(3)).

[48] *Id.* at 4772 (proposed at § 151.5(e)).

[49] *Id* at 4773 (proposed at § 151.6).

[50] *Id.* (proposed § 151.6(b)(4)).

Commission should decline to implement position visibility rules, even if it implements position limits.

With respect to the substance of the proposed hedge exemption, should the Commission proceed with implementation of the NOPR, the Utility Group requests it implement each of the following:

- If a trader exceeds position limits using the generic hedge exemption and files a timely Form 404 in good faith, it should not be subject to sanctions if the Commission finds fault with the trader's understanding of the validity of its hedging activity. Only intentional violations of limits should be subject to sanctions;

- If a trader files a timely Form 404A, it should be able to rely upon the requested anticipatory hedge exemption ten days thereafter. A trader's ability to hedge its commercial risk should not be impacted by a delay in the Commission's review and approval of its filing. If the Commission were to find, at a later time, that the requested exemption is unwarranted, the anticipatory hedge exemption could be prospectively terminated;

- "Complete books and records" retention requirements should not impose additional obligations beyond that contained in the current trade capture and recordation systems typically in place today. The Commission should also limit its "books and records" retention requirement to a period of one year; and

- As recommended above, the Commission should eliminate any requirement for any daily filings, particularly *bona fide* hedge-related filings. Unless such filings will be reviewed on a daily basis by the Commission, a trader should be able to file monthly aggregated filings. This will reduce the compliance burden and still permit the Commission to receive needed information.

XI. The Approval Process for The Waiver of Aggregation of Positions Should Be Modified And The Commission Should Exempt Companies That Operate Independently And Under Restrictions on the Sharing of Position Information

The Commission provides in the NOPR for entities with ten percent direct or indirect common ownership or control to receive an exemption from the requirement that their positions be aggregated for position limits purposes if they can effectively demonstrate that each operates independently of all others.[51] Although the Commission's acknowledgement of the need for the ability to obtain an exemption is clear, the manner in which the Commission has proposed to implement the waiver is problematic and would be highly inefficient.

The Commission has proposed that before receiving an exemption, commonly owned traders would be required to submit a detailed application to the Commission as well as provide any additional information required by the Commission.[52] Until the Commission grants an

[51] *Id.* at 4756.

[52] *Id.* at 4761.

exemption, the positions must be aggregated.

Processing exemption requests will be only one of the myriad of tasks undertaken by the Commission as a result of Dodd-Frank. As such, it will likely take the Commission a significant amount of time to process such applications. In the meantime, entities that operate independently, do not share data, and may be commercially or legally precluded from sharing data would have to aggregate their positions for position limits purposes. The Utility Group members are among the types of entities that are legally barred from sharing data under traditional public utility regulation. It is not unusual for the "regulated utility" to be separated by regulators from a "merchant generator" affiliate. For example, FERC rules applicable to Utility Group members generally require that the regulated utility and any merchant generator affiliate must have separate operations as a condition to their participating in the physical electricity markets.[53] Furthermore, some states may restrict or regulate the type of information that may be shared among affiliates of commonly controlled entities.[54] In such a case, the affiliates could not combine their positions even if they wanted to do so. The Commission should not require them to do so, even if for a temporary period.

Both state and federal laws and regulations require significant degrees of structural separation among regulated and unregulated operating subsidiaries of a utility holding company group, as well as a significant degree of financial insulation of one from the other. Under these circumstances, aggregation is both unnecessary and burdensome to administer (if possible at all), since operating information of the utility subsidiary must generally not be available to operating personnel of the unregulated group. Thus, imposition of an aggregated position limit as proposed in the NOPR would defeat public policies in place that require that these business activities remain structurally, operationally, and financially distinct. Moreover, as explained

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[53] *See*, *e.g.*, 18 CFR § 35.39 (c), (d).

[54] *See*, *e.g.*, CPUC Decision D.06-12-029 (Dec. 2006) (adopting the Affiliate Transaction Rules Applicable to California's Major Energy Utilities and Their Holding Companies), *available at* http://docs.cpuc.ca.gov/WORD_PDF/FINAL_DECISION/63087.PDF. Affiliate Transaction Rule IV.B states:

> A utility shall make non-customer specific non-public information, including, but not limited to information about a utility's natural gas or electricity purchases, sales, or operations or about the utility's gas-related goods or services and electricity-related goods and services, available to the utility's affiliates only if the utility makes that information contemporaneously available to all other service providers on the same terms and conditions, and keeps the information open to public inspection. . . . A utility is also permitted to exchange proprietary information on an exclusive basis with its affiliates, provided the utility follows all Commission-adopted pricing and reporting guidelines for such transactions, and it is necessary to exchange this information in the provision of the corporate support services permitted by Rule V.E below. The affiliate's use of such proprietary information is limited to use in conjunction with the permitted shared support services, and is not permitted for any other use.

CPUC Decision D.06-12-029 at Appendix A-3 at 9, *available at* *http://docs.cpuc.ca.gov/PUBLISHED/GRAPHICS/63089.PDF*.

Rule V.E specifies that "hedging and financial derivatives and arbitrage services" may not be shared between affiliates. *Id.* at 12.

below, position limits imposed in the circumstance of utility holding companies would penalize them by hindering or taking away the ability of each holding company group member to effectively hedge risks unique to its business circumstances.

Because of the highly-regulated nature of the electric power business, the Utility Group members are among the types of entities that must implement restrictions on data sharing between and among affiliates. Such restrictions are necessary to effect state and federal regulations that call for structural separation between regulated load serving entities and un-regulated entities that generate electric power for sale into wholesale power markets. To protect the interests of local ratepayers, it is not unusual for a "regulated utility" obligated to provide electric power supply and distribution service under the terms of a state-regulated franchise to be under common ownership with an unregulated "merchant generator" affiliate. In such a case, the affiliates and their holding company often must implement internal controls that accomplish structural separation of the commercial operation of the utility from that of the generator. Electric companies that operate under such a holding company structure have internal controls that ensure effective structural separation between the day-to-day operations of utility and generator affiliates. Currently, each affiliate can design and implement commercial hedging strategies tailored to address their individual risk profiles. If such commercial hedging programs were subordinated to even temporary limits calculated on an aggregate basis at the holding company level, such a requirement would significantly limit the commercial flexibility of the hedging and risk management programs of each affiliate whose positions may not be coordinated on a real-time basis.

Given the uncertain public benefits to be gained by position limits imposed without adequate information, application of aggregate position limits to structurally separate electric holding company group members would contravene public policy with no appreciable effect on the reduction of excessive speculation or systemic risk.

Therefore, the Commission should (1) permit persons that have filed for exemptions in good faith to receive an exemption which will become permanent upon action by the Commission; and (2) create an explicit exemption to the aggregation requirement for entities that are limited or barred by state or federal laws or regulations[55] from sharing information. Any other approach will create severe legal issues and be materially disruptive to the market.

XII. Conclusion

The Utility Group respectfully requests that the Commission not issue a final rule based on the NOPR at this time. The logic that underlies it – that limits on individual trader concentration will curb excessive speculation – is unsupported. In light of the significant Dodd-Frank implementation and compliance burdens and challenges that lie ahead for the Commission and swap markets participants, the Utility Group believes that the Commission and market participant resources are better deployed to implement required aspects of Dodd-Frank. The NOPR is not supported by empirical evidence and is overly complex and burdensome.

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[55] The Federal Energy Regulatory Commission ("FERC") also imposes restrictions on communications between affiliated companies that are subject to FERC regulation. *See, e.g.* 16 U.S.C. §§ 824d, 824e; 17 C.F.R. § 35.39 (2010) (FERC Affiliate Restrictions); 17 C.F.R. §§ 358.1-358.1 (2010) (FERC Standards of Conduct).

If the Commission, however, determines that it will proceed, it must offer a logical rationale with empirical supporting data for the proposed rules and design those rules to eliminate the unnecessary complexity and resulting substantial expense that compliance would require under the current proposal.

Respectfully submitted,

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