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March 28, 2011

FILE NO: 76142.2

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

VIA ELECTRONIC SUBMISSION

Re: *Position Limits for Derivatives,* RIN 3038–AD15 and 3038–AD16

Dear Secretary Stawick:

I. INTRODUCTION.

On behalf of the Working Group of Commercial Energy Firms (the "Working Group"), Hunton & Williams LLP hereby submits these comments in response to the request for public comment set forth in the Commodity Futures Trading Commission's (the "CFTC" or "Commission") Notice of Proposed Rulemaking, *Position Limits for Derivatives* (the "*Proposed Rule*"), published in the *Federal Register* on January 26, 2011,[1] which establishes position limits for certain physical commodity derivatives pursuant to newly amended Section 4a(a) of the Commodity Exchange Act ("CEA"), as established by Section 737 the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or the "Act").[2]

The Working Group is a diverse group of commercial firms in the energy industry whose primary business activity is the physical delivery of one or more energy commodities to others, including industrial, commercial, and residential consumers. Members of the Working Group are energy producers, marketers, and utilities. The Working Group considers and responds to requests for public comment regarding regulatory and legislative developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

1 *Position Limits for Derivatives,* Notice of Proposed Rulemaking, 76 Fed. Reg. 4752 (Jan. 26, 2011).

2 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010).

II. <u>EXECUTIVE SUMMARY</u>.

The Working Group strongly supports the goals of the Act to enhance transparency and reduce systemic risk in the swap markets. The Working Group appreciates the opportunity to provide the comments set forth herein and requests the Commission's consideration of such comments in order to adopt, if at all, position limits that are effective and workable for market participants.

As an initial matter, and as discussed in Part III.A, below, the Working Group submits that, prior to establishing and imposing speculative position limits in any specific market, the CEA requires the Commission to analyze the relevant markets and find that such position limits are indeed necessary. If implemented without sufficient study, speculative position limits will disrupt today's highly efficient energy commodity markets by (i) reducing liquidity, (ii) impairing price discovery, and (iii) preventing market participants from effectively and efficiently hedging their commercial risk exposure.

Additionally, as set forth in Part III.A, below, the Commission's proposal for Phase II single-month and all-months-combined ("AMC") position limits are entirely unnecessary, and accordingly, should be rejected. The Working Group submits that such limits could have significant adverse impacts on derivatives markets. As such, the Working Group strongly urges the Commission to use the discretion afforded to it pursuant to new CEA Section 4a(a) and decline the adoption of single-month and AMC position limits in any final rule issued in this proceeding at this time.

As discussed in Part III.B, below, the Working Group believes that there are several flaws in the proposed definition of a *bona fide* hedging transaction that could disrupt the efficient operation of energy commodity markets. In failing to provide a vehicle for market participants to apply for, and receive, an exemption from speculative position limits for "non-enumerated hedges," the Commission, contrary to the intent of Congress, has eliminated several important classes of transactions from the definition of a *bona fide* hedging transaction that are routinely undertaken in energy markets to hedge or mitigate commercial risk. The Working Group provides in Parts III.B.1, below, several examples of such excluded transactions. As illustrated by these examples, this proposed definition simply does not reflect the hedging practices generally used in commodity markets, especially energy markets. Specifically, as discussed in Part III.D, below, to qualify for a *bona fide* hedging exemption, the proposed definition appears to require market participants to match on a one-to-one basis a swap transaction to a specific physical transaction. Participants in energy commodity markets, however, frequently enter into swaps and futures to hedge underlying physical assets on a portfolio or aggregate basis. The Working Group submits that any final rule adopted by the Commission in this proceeding must preserve the ability of commercial energy firms to effectively and efficiently hedge their commercial risk exposure.

The Working Group further requests in Part III.C, below, that the Commission provide certainty to market participants as to how the process will work for applying for exemptions from speculative position limits should the Commission adopt one in any final rule. As written, the *Proposed Rule* provides an insufficient application process for exemptions and instead

requires market participants to file daily reports on their cash market commodity activities upon exceeding any position limit. The Working Group submits that this creates not only an unnecessary compliance burden on market participants but also a significant burden on the Commission who will have to review and evaluate daily such position reports. Should the Commission adopt an application process in any final rule, the Working Group strongly suggests that it provide market participants an opportunity to comment on such process.

As discussed more thoroughly in Part III.F, below, the Working Group believes the Phase I spot-month position limits must (i) be reconsidered in many respects and (ii) more appropriately accommodate the hedging needs of market participants. As recommended in Part III.F.1, below, the process for determining deliverable supply must be fully transparent and provide market participants the opportunity to comment on the DCM estimates of deliverable supply and any Commission proposal for spot-month position limits. Further, as set forth in Part III.F.2, below, with respect to the proposed spot-month position limits for cash-settled contracts, the Working Group submits that (i) the Commission's proposal to set the limit for cash-settled contracts equal to the level for physically-settled contracts is not grounded in a sound regulatory foundation, (ii) the proposal unduly restricts the position of cash-settled referenced contracts that may be held by market participants, and (iii) the proposed conditional exemption for cash-settled contracts inappropriately requires market participants to hold no physically settling futures contracts in order to qualify for such exemption. In Part III.F.3, below, the Working Group recommends that the Commission initially identify the universe of referenced paired contracts based only on those contracts that are cleared, and after such initial identification, identify which swaps constitute a referenced paired contract during its process for determining whether a swap must be mandatorily cleared pursuant to the Act.

Regarding the proposed visibility levels and related reporting requirements, the Working Group submits in Part III.G, below, that such are unnecessary in light of the transparency created by the Act and the Commission's existing special call authority. The Working Group believes that such requirements will result in a substantial and disproportionate burden on *bona fide* hedgers without providing any benefit to the markets.

Moreover, as discussed in Part III.I, below, the Working Group generally supports the proposed aggregation rules and disaggregation exemption as applied to "owned" non-financial entities. Yet it respectfully requests that the Commission (i) provide guidance on the required showing a market participant must make in demonstrating independent control, (ii) permit market participants discretion in using internal or external personnel to make any assessments relating to the independence of its owned non-financial entities, and (iii) confirm that the positions of owned non-financial subsidiaries or affiliates demonstrating independent control will not be aggregated with a parent financial entity.

Finally, and not of least importance, as discussed in Part III.J, below, the Working Group strongly recommends that the Commission conduct a thorough cost-benefit analysis of this *Proposed Rule*, which should include the costs presented in the Paper Reduction Act section of the *Proposed Rule.*

III. COMMENTS OF THE WORKING GROUP OF COMMERCIAL ENERGY FIRMS.

A. THE COMMISSION HAS NOT ESTABLISHED THE FOUNDATION FOR THE IMPOSITION OF FEDERAL SPECULATIVE POSITION LIMITS FOR EXEMPT AND ALL AGRICULTURAL COMMODITIES.

As a threshold matter, the Working Group respectfully submits that Congress did not mandate the establishment of speculative position limits for exempt and all agricultural commodities or authorize the Commission to so impose them without an analysis and finding of the need for, or appropriateness of, speculative position limits in any specific market.[3] This issue has been addressed in comment letters filed in response to the Commission's January 26, 2010 Notice of Proposed Rulemaking, *Federal Speculative Limits for Referenced Energy Contracts and Associated Regulations*,[4] and in pre-rulemaking comments filed in connection with the potential implementation of speculative position limits under Dodd-Frank.[5] Moreover, the Working Group is informed that other interested parties will address this issue in their comments submitted in this rulemaking proceeding. The Working Group supports the principle that the CEA requires additional analysis before the Commission can finalize a speculative position limit rule for exempt and all agricultural commodities.

In Section III.F, below, the Working Group presents its concerns regarding the proposed spot-month limits for referenced contracts should the Commission move forward and implement such limits using the phased approach outlined in the *Proposed Rule*. In addition to its concerns regarding the proposed Phase I spot-month limits, the Working Group submits that imposing position limits for non-spot months and AMC could result in significant, unintended adverse impacts on derivatives markets, particularly markets for energy commodities.

The *Proposed Rule* fails to provide any verified, empirical data, or cost-benefit analysis justifying the imposition of Phase II non-spot-month and AMC limits that can be reviewed and commented upon by interested parties—even on a prophylactic basis. Notwithstanding this lack of analysis, non-spot month and AMC position limits are unnecessary if the Commission develops appropriate spot-month limits. As such, the Working Group strongly recommends the Commission use the discretion afforded under new CEA Section 4a(a) and forego the implementation of Phase II non-spot month and AMC position limits in any final rule issued in this proceeding.

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[3] *See* CEA Sections 4a(a)(2)-(5) (requiring that the Commission establish position limits "as appropriate").

[4] *See Federal Speculative Limits for Referenced Energy Contracts and Associated Regulations,* Notice of Proposed Rulemaking, 75 Fed. Reg. 4144 (Jan. 26, 2010); *The Futures Industry Association, Inc*., Comment Letter (Mar. 8, 2010); *International Swaps and Derivatives Association, Inc.* ("ISDA"), Comment Letter (April 16, 2010); *Working Group of Commercial Energy Firms*, Comment Letter (April 26, 2010).

[5] *See CME Group,* Pre-Rulemaking Position Limit Comments (Oct. 25, 2010); *The Futures Industry Association, Inc.,* Pre-Rulemaking Position Limit Comments and Recommendations ("FIA Pre-Rulemaking Comments") (Oct. 1, 2010).

The comments that follow are submitted by the Working Group to address concerns with respect to specific provisions in the *Proposed Rule* so that a final rule, if one is ultimately adopted, will contain the clearest and most workable provisions.

B. THE PROPOSED DEFINITION OF A *BONA FIDE* HEDGING TRANSACTION IS SERIOUSLY FLAWED.

The Working Group submits that there are several, very specific and somewhat technical, flaws in the proposed definition of a *bona fide* hedging transaction that threaten its utility for commercial energy firms. As such, the Working Group provides the following comments addressing its concerns with specific provisions of the *Proposed Rule* and respectfully requests that the Commission address each of them prior to the adoption of any final rule. Doing so will ensure that any final rule adopted by the Commission in this proceeding will be clearer and more workable (*i.e.,* commercially practicable).

1. There is No Basis for the Elimination of "Non-Enumerated" Hedges.

Without much explanation, the Commission excluded from proposed CFTC Rule 151.5 provisions that would define "non-enumerated hedges" or provide a vehicle for a commercial energy firm to apply for, and receive, an exemption from speculative position limits for "non-enumerated hedges."[6] In contrast, the *Proposed Rule* provides that the only transactions or positions that would be recognized as *bona fide* hedges would be those described under proposed CFTC Rule 151.5(a)(2) as "enumerated hedges." Specifically, the proposed rule states, in relevant part:

> "[N]o transactions or positions shall be classified as *bona fide* hedging for purposes of § 151.4 unless . . . the provisions of paragraph (a)(2) of this section have been satisfied."[7]

In taking this position (hereinafter referred to as the "Enumerated Hedges Only" provision), the Commission has eviscerated the general definition of *bona fide* hedging transactions or positions as set forth in proposed CFTC Rule 151.5(a)(1), which came directly from CEA Section 4a(c)(2), as amended by Dodd-Frank. Significantly, the Commission has effectively eliminated from the *bona fide* hedging definition numerous classes of transactions

[6] The analogs in existing Commission regulations are Sections 1.3(z)(3) and 1.47. Under the *Proposed Rule*, Section 1.3(z) would not apply to speculative position limits for exempt and agricultural commodities and Section 1.47 would be deleted altogether.

[7] Proposed CFTC Rule 151.5(a)(1).

that Congress intended to include.[8] The Working Group identifies and describes several of these transactions in subparts III.B.1.i-III.B.4, below.

The Working Group respectfully submits that it is neither in the public interest nor is it in the Commission's interest as a market regulator to structure a rule that eliminates its flexibility to allow hedge exemptions based on "non-enumerated hedging transactions." Markets are dynamic. Many of the proposed rules being implemented by the Commission pursuant to Dodd-Frank, particularly this *Proposed Rule*, may have the result of diminishing liquidity in certain markets. Thus, the Working Group submits that the Commission should preserve its ability to allow exemptions based upon non-enumerated transactions.[9]

Accordingly, in order to ensure consistency with the statutory language of new CEA Section 4a(c) and avoid harmful impacts to markets for Referenced Contracts, the Working Group suggests that the Commission (i) strike the last clause in proposed CFTC Rule 151.5(a)(1)(iv)(B)—"and the provisions of paragraph (a)(2) of this section have been satisfied;" and (ii) revise the lead-in language of proposed CFTC Rule 151.5(a)(2) to add following the word "includes" the phrase ", but is not limited to,". Specifically, the Working Group proposes the following revisions:

§ 151.5 Exemptions for referenced contracts.

(a) *Bona fide hedging transactions or positions.*

(1) Any trader that complies with the requirements of this section may exceed the position limits set forth in § 151.4 to the extent that a transaction or position in a referenced contract:

. . . .

(iv) Reduces risks attendant to a position resulting from a swap that—

. . . .

(B) Meets the requirements of paragraphs (a)(1)(i) through (a)(1)(iii) of this section. Notwithstanding the foregoing, no transactions or positions shall be classified as *bona fide* hedging for purposes of § 151.4 unless such transactions or

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[8] In addition, the Commission's proposal simultaneously establishes and eliminates the availability of the so-called "pass-through" exemption identified in proposed CFTC Rule 151.5(a)(1)(iv)(A) and CEA Section 4a(c)(2)(B). To be certain, proposed CFTC Rule 151.5(a)(1)(iv)(A) is nearly identical to the discretionary pass-through provision in new CEA Section 4a(c)(2)(B). As such, the Commission clearly sought to establish a pass-through exemption. And yet the Commission's proposed CFTC Rule 151.5(a)(2) would eliminate the use of any such exemption. The Working Group believes that the Commission likely did not intend such a result.

[9] This does not mean that the Commission is compelled to grant exemptions—it will retain its discretion on a case-by-case basis based on the market's ability to support it, among other things. What it does mean, however, is that if the Commission believes an exemption may be warranted to add liquidity to a particular market at a particular time it would not be forced to promulgate an amendment to Part 151.5 in order to do so.

> positions are established and liquidated in an orderly manner in accordance with sound commercial practices~~ and the provisions of paragraph (a)(2) of this section have been satisfied~~.
>
> (2) *Enumerated Hedging Transactions.* The definition of bona fide hedging transactions and positions in paragraph (a)(1) of this section includes**, but is not limited to,** the following specific transactions and positions: . . . .

Subparts III.B.1.i-III.B.4, below, address the identified flaws with the Commission's current proposal for the definition of a *bona fide* hedge, and support the Working Group's recommendation to revise the proposed language of the *bona fide* hedging transaction definition.

i. Hedges Relating to Assets that a Person Anticipates Owning or Merchandising Would Not Constitute *Bona Fide* Hedges under the *Proposed Rule*.

Proposed CFTC Rule 151.5(a)(1) includes as a *bona fide* hedge the anticipated ownership, production, manufacture, processing, or merchandising of an exempt or agricultural commodity.[10] Yet proposed CFTC Rule 151.5(a)(2), which sets forth "Enumerated Hedging Transactions," does not contain a parallel provision. Indeed, only "unsold anticipated production"[11] and "unfilled anticipated requirements," including requirements for "processing, manufacturing, and feeding"[12] qualify as enumerated hedges. Thus, as a result of the Enumerated Hedges Only provision, certain transactions entered into to hedge anticipated ownership or merchandising of an exempt or agricultural commodity would not qualify as *bona fide* hedging transactions under the *Proposed Rule*.[13] The Working Group provides two such examples.

Example 1.

At 8:00 a.m. commercial energy firm X becomes aware of the availability of a spot cargo of heating oil moving from Europe to the United States. Firm X believes that it can acquire the cargo over the next few hours or days, manage the discharge of the product at the end of the voyage, and re-sell the heating oil to a distributor in the northeast at the end of the month. While Firm X begins negotiations to purchase and re-sell the cargo, it is not concerned about upward price risk during the period of its purchase negotiations but is seriously concerned about downward price risk between now and the time it establishes its sale price. It sells New York Mercantile Exchange ("NYMEX") heating oil futures contracts for its expected delivery month. Under the Commission's proposal, this transaction would not qualify as a bona fide hedge.

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[10] *See* analogous new CEA Section 4a(c)(2).

[11] Proposed CFTC Rule 151.5(a)(2)(i)(B).

[12] Proposed CFTC Rule 151.5(a)(2)(ii)(C).

[13] To the extent that language in the enumerated hedging section of the proposal parallels language in the enumerated hedging section of current Rule 1.3(z), the Working Group submits that the impact is different as a result of the elimination of the availability of an exemption for non-enumerated hedges.

<u>Example 2</u>.

Utility X periodically issues requests for proposals ("RFP") looking to obtain fixed price electricity supply for groups of its customers. For example, it may be looking for a fixed price for electricity for a term of three (3) years for its commercial customer class. In its RFP, Utility X requires that Bidders provide firm electricity at a fixed price and at designated locations on its electrical system. As it is for Full Requirement, Bidders must ensure that enough electric supply is delivered to Utility X so that it can meet the load requirements of its commercial customers. Actual deliveries of electricity are equal to actual usage of electricity by Utility X's commercial customers and results in physical delivery of electricity. Finally, the RFP requires that the fixed price offer be provided on or before the close of business, March 31, and be left open; that is, the price quoted must remain firm while Utility X evaluates and then selects the winning bidder on April 3.[14]

Power Marketer Y is preparing to respond to Utility X's RFP. It believes it can arrange for a physical supply of electricity supply on competitive terms. However, Power Marketer Y is concerned that prices in the electricity market will increase while it is holding open its fixed price for Utility X and then completing the transaction for the physical supply. Power Marketer Y enters into an electricity swap to protect against increases in prices while it leaves open the bid during the three day evaluation period and thereafter completes negotiations for the physical electricity purchase if Utility X accepts its price quote. Under the Commission's proposal, the electricity swap transaction would not qualify as a bona fide hedge. If Power Marketer Y faces position limit restrictions in this situation, it would have to raise its fixed price quote to Utility X to account for the risk of the price moving and this could result in higher costs to Utility X's customers.

The Working Group notes that the variance in the treatment of marketing or merchandising activities and the treatment of producers or processors in the *Proposed Rule* is remarkably similar to the differential treatment of cash market "trading" positions provided in footnotes 23 and 128 of the proposed rules implementing the End-user Exception and further defining the term Major Swap Participant, respectively, and upon which the Working Group commented in the relevant proceedings.[15] The Working Group's concern was that in those proposed rules, the Commission appeared to take the position that a marketer or merchandiser that acquired a commodity for resale (*i.e.*, a cash market "trading" position) would not be entitled to treat a hedge of that position as "mitigating or reducing commercial risk" in order to avail itself of the end-user exception or certain calculations in connection with the definition of Major Swap Participant.

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[14] Often times, commercial energy firms competing to serve load under similar RFP arrangements have been required to leave in place fixed price quotes longer than the four (4) day window set forth in the example above.

[15] *End-User Exception to Mandatory Clearing of Swaps,* Notice of Proposed Rulemaking, 75 Fed. Reg. 80,747 (Dec. 23, 2010) ("Proposed End-User Exception Rule"); *Working Group of Commercial Energy Firms,* Comment Letter (Feb. 22, 2011); *Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant,"* 75 Fed. Reg. 80,174 (Dec. 21, 2010); *Working Group of Commercial Energy Firms,* Comment Letter (Feb. 22, 2011).

As in the instant proceeding, such differential treatment in those proposed rules would effectively eliminate "merchant,"[16] "merchandiser,"[17] or "middlemen"[18] from the litany of commercial parties historically recognized as part of the chain from the production to the consumption of commodities. These parties own physical commodities and bear significant price risk as a result. The Working Group respectfully submits that this result is contrary to the CEA and that the use of derivatives by these firms to hedge that risk should qualify as *bona fide* hedges and as "hedging and mitigating commercial risk" under the Commission's rules.

ii. Hedges of Services Would Not Constitute *Bona Fide* Hedges Under the *Proposed Rule*.

Proposed CFTC Rule 151.5(a)(1) would include as a *bona fide* hedging transaction "services that a person provides or purchases, or anticipates providing or purchasing."[19] However, proposed CFTC Rule 151.5(a)(2), which sets forth Enumerated Hedging Transactions, does not contain a parallel provision. Thus, under the Enumerated Hedges Only provision, hedges of the potential change in value of services would not constitute as *bona fide* hedging under the Commission's proposal. The Working Group provides the following two examples to illustrate such hedges.[20]

Example 1.

Commercial energy firm Z is a wholesale marketer of natural gas. It has an opportunity to acquire one year of firm transportation on Natural Gas Pipeline ("NGPL") from the Texok receipt point to the Henry Hub delivery point for an all-in cost of $.30/mmbtu. The "value" of that service at that time is $.33/mmbtu, measured as the difference between the price at which one can sell the natural gas at the delivery point minus the price at which one can purchase the gas at the receipt point. At that time, commercial energy firm Z can enter into a swap locking in the calendar 2012 strip at Texok at a price of $4.00/mmbtu and sell a calendar strip of NYMEX Henry Hub natural gas futures contracts locking in a sale price at a weighted average of $4.33/mmbtu. Entering into those two separate transactions without having actually purchased or sold natural gas to transport has allowed commercial energy firm Z to hedge the value of the

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16 *See* 17 C.F.R. § 32.4(a) (2010) ("a producer, processor, or commercial user of, or a merchant handling, the commodity" may be an offeree of an option under the trade option exemption) (emphasis added).

17 *Exemption for Certain Contracts Involving Energy Products*, 58 Fed. Reg. 21,286 (Apr. 20, 1993) (granting exemptive relief in response to an application filed by a group of entities which represented that each was a producer, processor and/or merchandiser of crude oil, natural gas and/or crude oil and natural gas products, or was otherwise engaged in a commercial business in these commodities).

18 *See* Section 4a(c) of the CEA ("producers, purchasers, sellers, middlemen, and users of a commodity or product derived therefrom" should be eligible for hedge exemptions) (emphasis added).

19 *See* analogous new CEA Section 4a(c)(2).

20 Without impacting their illustrative value, these examples have been simplified, and certain factors, such as the time value of money, have been eliminated.

firm transportation service that it holds or can acquire.[21] *However, under the Commission's proposal, the transaction would not qualify as a bona fide hedge transaction.*

Example 2.

Natural Gas Producer X has new production coming on line over the next few years in the Gulf of Mexico. The production is located near Point A on Pipeline Y's interstate natural gas pipeline system. Producer X has the desire to sell gas to customers in Region B as the price for natural gas in Region B is significantly higher than at Point A, where natural gas would currently be delivered into Pipeline Y's system. Producer X contacts Pipeline Y and negotiates a Precedent Agreement with the pipeline under which Pipeline Y will build new transportation capacity from Point A to Region B. Under the Precedent Agreement, Producer A is obligated to pay demand charges to the pipeline for a term of 5 years from the date the pipeline goes into commercial operation, if Pipeline Y is able to complete a successful open season and obtains the necessary permits to construct and operate the new section or expansion of its pipeline system from Point A to Region B. The open season is designed to attract commitments from other potential shippers to help support the cost of building and operating the pipeline expansion. The schedule calls for a completion of construction and commercial operation of the pipeline expansion on March 31, 2013.

Producer X is concerned that the natural gas price differential between Point A and Region B could collapse and is fairly confident the expansion project will be completed. In order to manage the risk associated with the 5-year financial commitment to Pipeline Y, i.e., pipeline demand charges, Producer X enters into swaps at Point B for a term of April 1, 2013 to March 31, 2018, to lock-in the price spread between Point A and Region B. Under the Commission's Proposed Rule, the swap transactions would not qualify as bona fide hedges. In this case, the expansion of the pipeline system that would afford customers in Region B more access to lower priced gas might not occur without the ability to count the swaps associated with this transaction as a bona fide hedge.

Example 3.

Commercial energy firm A is an electric utility that owns coal-fired generation facilities. Firm A enters into contracts with major railroads to transport coal from producing regions to its various generating facilities. One or more of these contracts are subject to a fuel surcharge, whereby rates paid by firm A to transport coal are indexed to the price of diesel fuel. As prices for the diesel fuel rise, the rate paid by firm A to transport coal also rises. To mitigate this risk, firm A could enter into a long position in futures contracts or swaps for the diesel fuel, whereby gains realized on these instruments should prices rise would off-set any increase in the rate paid by firm A to transport coal. Under the Proposed Rule, however, these transactions would not qualify as bona fide hedge transactions since they would be entered into as a hedge of services—in this case, coal transportation services.

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[21] Note that this "value" exists whether commercial energy firm Z ever owns or intends to own the physical commodity. In some circumstances, the firm might choose to release the capacity to a third-party and realize the value of the transportation service from the capacity release transaction.

2. Spreads and Arbitrage Positions Would Not Qualify as Bona Fide Hedges Under the Proposed Rule.

Section 4a(a) of the CEA both before and after the passage of Dodd-Frank authorizes the Commission to "exempt[] transactions normally known to the trade as 'spreads' or 'straddles' or 'arbitrage' or from fixing limits applying to such transactions or positions different from limits fixed for other transactions or positions." Under the regimes for speculative position limits currently administered by both NYMEX and the IntercontinentalExchange ("ICE"), exemptions from speculative position limits are available for arbitrage, intra-commodity spread, inter-commodity spread, and eligible option/option or option/futures spread positions.[22] Under the *Proposed Rule*, these classes of transactions would not qualify for an exemption.

Arbitrage and spread positions create a limited risk of causing sudden or unreasonable fluctuations or unwarranted changes in the price of a commodity. In fact, they are universally recognized as transactions that limit unwarranted changes in price by tying the price of one instrument to another, creating a market efficiency that reduces the risk of aberrational pricing. The Working Group submits that there has never been an issue of sudden or unreasonable fluctuations or unwarranted changes in price attributable to arbitrage or spread positions that would justify the elimination of exemptions for such transactions at this time.

The Working Group respectfully suggests that the fact that these positions currently exist in the market and may be the basis for an exemption from limits on both NYMEX and ICE requires that the Commission consider the potential negative impact on liquidity if such positions were no longer to be permitted such treatment. Therefore, as provided for under CEA Section 4a(a), the Commission should permit exemptions from position limits for transactions such as spreads or arbitrage.

3. Cross-Commodity Hedges Would Not Be Permitted to Be Carried into the Spot Month.

Proposed CFTC Rule 151.5(a)(2)(v) would permit cross-commodity hedges "provided that the positions shall not be maintained during the five last trading days of any referenced contract." This would result in transactions, such as the one set forth in the following example, being excluded from treatment as a *bona fide* hedging transaction.

Example.

Commercial energy firm J supplies jet fuel to airlines at a variety of airports in the United States, including Houston Intercontinental Airport. It has a fixed-price contract to purchase jet fuel from a refinery on the gulf coast during early June. Because there is no liquid jet fuel futures contract, commercial energy firm J uses the June NYMEX physically-delivered WTI crude oil futures contract to hedge its price risk. Under the Proposed Rule, commercial

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[22] *See* NYMEX Rule 559.C and *ICE OTC Regulatory Rulebook for Significant Price Discovery Contracts, Rule* 1.17 ("ICE OTC Rule 1.17").

energy firm J would be required to liquidate its hedge during the last five trading days of the June contract and either remain unhedged or replace its June hedge with a contract that represents a completely different delivery period and, therefore, a different supply/demand and pricing profile.

4. The Working Group Questions the Phraseology Used in the *Proposed Rule* that Would Treat as *Bona Fide* Hedges "Purchases of Referenced Contracts" on the One Hand, and "Sales of Any Commodity Underlying Referenced Contracts" on the Other.

The purpose and effect of the distinction presented in proposed CFTC Rule 151.5(a)(2) are unclear to the Working Group. Specifically, the lead-in language to proposed subpart 151.5(a)(2)(ii) states that "purchases of *referenced contracts*" may qualify as *bona fide* hedges provided certain conditions are met. In contrast, the lead-in language to proposed subpart 151.5(a)(2)(i) states that "sales of *any commodity underlying referenced contracts*" may qualify as *bona fide* hedges provided the right conditions are met. Nowhere in the *Proposed Rule* does the Commission explain the purpose behind this distinction. Under the analogous provisions of Section 1.3(z) of the Commission's current regulations,[23] purchases and sales are treated equally—that is, purchases or sales of futures contracts (and not the underlying commodity) may qualify as *bona fide* hedging transactions. Thus, it appears that the phrase "any commodity underlying" ought not to be included in proposed CFTC Rule 151.5(a)(2). The Working Group respectfully requests that in any final rule issued in this proceeding the Commission either (i) harmonize the two provisions in the *Proposed Rule*, or (ii) clarify the intent and purpose behind the distinction should the Commission adopt such language.

C. THE PROCESS FOR APPLYING FOR, AND RECEIVING, EXEMPTIONS FROM SPECULATIVE POSITION LIMITS IS ALSO FLAWED.

1. The *Proposed Rule* Unnecessarily Abandons the Current Energy Market Process of Applying in Advance for Exemptions from Speculative Position Limits.

Current practice on both NYMEX and ICE permits a commercial energy firm to apply, in advance, for an exemption from speculative position limits. With the exception of exemptions for "anticipated unsold production" and "anticipated unfilled requirements,"[24] the *Proposed Rule*

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[23] 17 C.F.R. § 1.3(z).

[24] *See* proposed CFTC Rule 151.5(c) (with respect to hedging anticipated unsold production or anticipated unfilled requirements, a trader must submit to the Commission a 404A filing at least ten days in advance of the date that such transactions or positions would exceed the applicable position limits). *See also* proposed CFTC Rule 151.5(c)(1)(ii), (iv), and (v) (each subsection contains the phrase "which may not exceed one year"). This restriction, however, should only be applied to referenced agricultural commodities. The Working Group is also concerned that this proposed rule could be read to effectively restrict the ability of participants in exempt commodity markets to hedge exposure to price volatility for transactions that are more than one year in duration. The Commission should clarify and, as necessary, rectify, the language of proposed CFTC Rule 151.5(c)(1)(ii), (iv), and (v) to avoid such a result.

abandons that construct. The Working Group respectfully submits that such an approach is flawed for the reasons set forth below.

i. The *Proposed Rule* Creates Uncertainty for Market Participants.

Under current practice, a market participant would apply for an exemption from speculative position limits that would allow it to hold positions subject to the exemption up to a stated quantity. Such practice provides commercial energy firms with certainty and precise knowledge as to what the exchange (*i.e.,* NYMEX) or exempt commercial market ("ECM") with significant price discovery contracts (*i.e.,* ICE), as applicable, will permit. Unlike current practice, the *Proposed Rule* leaves the upper limit of an exemption undefined.[25] Unless the Commission is proposing that there is no upper limit for *bona fide* hedge transactions, which is highly doubtful, then the proposed process leaves a market participant without any knowledge as to when its positions will be deemed by the Commission to be "too much."

By way of example, assume the speculative position limit for an energy commodity is 1,000 contracts, and a commercial energy firm with significant inventory could justify an exemption to allow it to hold 6,000 contracts. In NYMEX's view, however, the market could support an exemption only to a level of 3,000 contracts. Under current practice, the commercial energy firm would know, in advance, that the potential acquisition of additional cash market risk would not result in additional room to hedge on NYMEX and could make a considered decision to make, or not make, the acquisition, knowing it might have to hold it unhedged.

In contrast, the *Proposed Rule* does not provide a market participant the opportunity to know in advance what the Commission would determine to be the upper limit that the market could support. Pursuant to the *Proposed Rule*, a market participant must make the required filings with the Commission upon reaching the position limit of 1,000 contracts. In accordance with its internal policies and business practice, a market participant would continue to increase its position and make the corresponding required filings without ever knowing when and at what level the Commission would say "enough."

The Working Group believes that, at some point, the Commission would say "enough" on the same basis that NYMEX currently limits exemption levels even when they would be fully justified based upon a participant's cash market exposure. Yet the *Proposed Rule* makes no provision for when or how the Commission would establish an upper bound, and fails to state whether a market participant would be required to liquidate or offset positions established in good faith before an upper bound was communicated. Commercial energy firms cannot afford to operate under this process, or lack thereof, as it creates a high level of uncertainty.

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[25] The Commission would be fully justified under the CEA to make such a determination to leave the upper limit of an exemption undefined. *See* CEA Sections 4a(a)(2)(A) and 4a(a)(5)(A). If that was the Commission's intention behind this proposed exemption process, the Working Group would fully support it.

ii. The Commission Should Provide Clear Guidance on the Application Process for Hedge Exemptions Should It Adopt One in Any Final Rule Issued in the Proceeding.

Should the Commission adopt an application process for *bona fide* hedge exemptions in any final rule issued in this proceeding, the Working Group suggests that the Commission provide clear guidance on such process and permit market participants an opportunity to comment.[26] Any application process adopted by the Commission should require market participants to apply for exemptions only once. Currently, market participants seek exemptions from the exchanges. Yet, under any final rule adopted by the Commission, market participants should not be required to apply for exemptions from both the CFTC and the exchanges. Such a requirement would impose significant burdens on market participants.[27]

iii. Daily Reporting of Cash Market and Other Positions is Burdensome and Unnecessary.

Under current practice on both NYMEX and ICE, a party with a hedge exemption is not required to make regular filings with the exchange or ECM. Nevertheless, a market participant remains subject to inquiry by NYMEX or ICE[28] and the requirement to justify the use of the exemption. Additionally, the market participant remains subject to the special call authority of the CFTC[29] and an enforcement action if such market participant used an exemption to hold speculative positions in excess of the position limit.

Under the *Proposed Rule*, a party will be required to submit ***daily*** reports itemizing the following information with respect to such position: (1) the cash market commodity hedged, the units in which it is measured, and the corresponding referenced contract that is used for hedging the cash market commodity; (2) the number of referenced contracts used for hedging; (3) the entire quantity of stocks owned of the cash market commodity that is being hedged by a position in a referenced contract; (4) the entire quantity of open fixed price purchase commitments in the hedged commodity outside of the spot month of the corresponding referenced contract; (5) the entire quantity of open fixed price purchase commitments in the hedged commodity in the spot month of the corresponding referenced contract; (6) the entire quantity of open fixed price sale commitments in the hedged commodity outside of the spot month of the corresponding referenced contract; and (7) the entire quantity of open fixed price sale commitments in the

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[26] The Working Group notes that in a prior rulemaking to establish federal speculative position limits, the Commission sought to establish an application process for *bona fide* hedge exemptions. *See Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations*, Notice of Proposed Rulemaking, 75 Fed. Reg. 4144 (Jan. 26, 2010).

[27] In addition to providing market participants with the ability to provide comments on the application process in the context of the instant rulemaking, the Working Group suggests that the Commission also host a technical conference or other forum to permit market participants to interface with the Commission and make recommendations. Upon issuance of a proposed application process, the Commission should then provide an appropriate opportunity for comment.

[28] *See* NYMEX Rule 559; ICE OTC Rule 1.16.

[29] *See* 17 C.F.R. § 18.05; 21 (2010).

hedged commodity in the spot month of the corresponding referenced contract.[30] Building the system to perform such reporting will be a significant and unnecessary expense, and the management and execution of the system to satisfy the daily reporting obligation an unnecessary burden.

iv. Daily Review of Positions is a Burden that the Commission Does Not Need to Impose Upon Itself.

In order to manage the speculative limit regime that the Commission is proposing to establish, CFTC staff will be required to review and evaluate daily the positions of all market participants that exceed the speculative position limits. First, as described in Part III.C.1.i, above, CFTC staff will need to do so to determine when to say "enough" to a *bona fide* hedger with legitimate hedging needs that may be greater than the market for a particular instrument can bear. Second, staff will also need to do so to verify the veracity of a market participant's claim of eligibility for a hedge exemption, something that is currently only done on a periodic basis. The Working Group respectfully submits that the monitoring and verification obligations placed on CFTC staff will require the expenditure of considerable Commission resources and are unnecessary, especially at a time of significant budgetary constraint.

D. The Proposed Framework for *Bona Fide* Hedge Exemptions Should Reflect the Hedging Practices of Commodity Markets.

In addition to the Working Group's specific concerns regarding the technical flaws with the proposed definition of the *bona fide* hedging exemption and the process of applying for an exemption, the Working Group respectfully requests the Commission to recognize that, although market participants in physical energy commodity markets use swaps and futures to hedge underlying physical positions, they frequently do not execute such transactions specifically for the purpose of hedging a specified underlying physical position (*i.e.,* on a one-for-one basis). Prudent risk management practices generally involve hedging underlying physical assets and related positions on a portfolio or aggregate basis.[31] A commercial firm will normally hedge

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[30] *See* proposed CFTC Rule 151.5(b).

[31] The Working Group notes that, in the CFTC's proposed rule on the end-user exception from mandatory clearing, the Commission recognizes that whether a position is used to hedge or mitigate commercial risk should be determined by the facts and circumstances at the time the swap is entered into, and should take into account the person's overall hedging and risk mitigation strategies. *See* Proposed End-User Exception Rule, at 80,753. In relevant part, the Proposed End-User Exception Rule states:

> As a general matter, the Commission preliminarily believes that whether a position is used to hedge or mitigate commercial risk should be determined by the facts and circumstances at the time the swap is entered into, and should take into account the person's overall hedging and risk mitigation strategies. The Commission expects that a person's overall hedging and risk management strategies will help inform whether or not a particular position is properly considered to hedge or mitigate commercial risk for purposes of the clearing exception.

The Working Group respectfully submits that the Commission should take this same approach herein and recognize that the determination of what is a *bona fide* hedge transaction is informed by a market participant's overall hedging and risk management strategy.

these exposures utilizing physical transactions, futures, and swaps, the exact combinations of which will be determined by various characteristics that may be unique to such firm.

Further, in order to effectively and efficiently mitigate commercial risk associated with underlying physical assets and related positions, commercial energy firms will also dynamically hedge their aggregate exposures on a regular and on-going basis to optimize the value of underlying physical assets or portfolios. A key aspect of dynamic hedging is the ability to modify the hedging structure related to the physical asset or positions when the relevant pricing relationships applicable to that asset change. Dynamic hedging may involve leaving an asset or position unhedged when necessary to mitigate the risk of lost opportunity costs, which may require hedges to be established, unwound, and re-established on an iterative basis over time.

In this context, the concept of *bona fide* hedging should include all hedging activity that maximizes the value of the asset. The adoption of a prescriptive one-to-one matching requirement of each swap to a specific physical transaction or an asset position is inconsistent with the hedging practices of many participants in commodity markets, particularly energy markets, and is thus unnecessary and overly burdensome.[32] As such, the Working Group requests that the Commission modify its hedge exemptions and their related reporting requirements to reflect more appropriately the actual hedging practices of participants in energy markets in any final rule it adopts in this proceeding.

E. THE PASS-THROUGH PROVISION IS NOT REQUIRED, AND THEREFORE, THE COMMISSION SHOULD ADOPT AN ALTERNATIVE APPROACH: PERMIT RISK MANAGEMENT EXEMPTIONS FROM POSITION LIMITS.

As amended by Title VII of the Act, new CEA Section 4a(c)(2)(B) permits the pass-through of a *bona fide* hedge exemption from speculative position limits to swap dealers taking the other side of a hedge transaction from an end-user. In relevant part, new CEA Section 4a(c)(2)(B) states:

> (2) For the purposes of implementation of subsection (a)(2) for contracts of sale for future delivery or options on the contracts or commodities, the Commission shall define what constitutes a *bona fide* hedging transaction or position as a transaction or position that—
>
> . . . .
>
> (B) reduces risks attendant to a position resulting from a swap that—

[32] For example, a commercial energy firm may enter into several swap transactions to hedge a single physical position. This approach is used to spread out risk among different counterparties and to obtain the best overall pricing possible for the hedge. Given the dynamic and volatile nature of energy markets, it is very difficult for a commercial energy firm or any other market participant to assert on an intra-day, real-time basis or at a later point in time whether a particular swap or futures transaction is functioning as a hedge. Under this example, it would be difficult, if even possible, for a swap dealer to step into the shoes of its commercial counterparty on a transaction-by-transaction basis for purposes of applying the pass-through provisions of CEA Section 4a(c)(2)(B).

> (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).

This discretionary provision effectively allows a swap dealer to "step into the shoes" of a commercial firm or end user counterparty for purposes of being exempted from applicable speculative position limits.

1. **The Pass-Through is No Longer Required; the Concerns Over Risk Management Exemptions Have Been Ameliorated.**

The Working Group submits that the transparency created in exempt commodity markets by Title VII of the Act, together with the Commission's exemptive authority under new CEA Section 4a(a)(7), render this pass-through provision unnecessary.

The Working Group supports pre-rulemaking comments submitted by other interested parties[33] recommending that the Commission continue its practice of granting arbitrage and risk management exemptions from position limits for positions that serve the same or similar function as a *bona fide* hedge position, but do not fall squarely within the definition of a *bona fide* hedge.[34] Risk management exemptions from position limits are essential to the risk management practices of commercial energy firms; however, such exemptions had come under scrutiny because they allowed a swap dealer to get a hedge exemption to hedge the risk of swaps opposite speculative traders whose swap positions were unknown to the Commission and were subject to neither position limit nor accountability rules. Under Dodd-Frank, those concerns are no longer present. That is, virtually all swap transactions will be reported to swap data repositories ("SDRs"), prices will be reported to the public, and the parties will be subject to large trader reporting rules. Accordingly, the Commission may grant risk management exemptions on the basis of a party's need, ability to manage the positions, and the ability of the market to support the positions, all without concern that it has enabled a "dark market" with attendant risks of "excessive speculation."

Section 4a(a)(7) provides the Commission with broad authority to exempt any persons or transactions from speculative position limits that it sets under Section 4a. The Working Group respectfully submits that the Commission exercise its exemptive authority to grant exemptions in appropriate circumstances rather than establish a pass-through exemption, the need for which has been significantly diminished given the transparency created in exempt commodity markets by the Act.

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[33] *See* FIA Pre-Rulemaking Comments at 8; *Morgan Stanley,* Position Limits Pre-Rule Proposal Comments and Recommendations, at 10 (Oct. 25, 2010).

[34] Section 4a(a) of the CEA states: "[N]othing in this section shall be construed to prohibit the Commission from . . . exempting transactions normally known to the trade as 'spreads' or 'straddles' or 'arbitrage.'"

2. If Adopted, the Pass-Through Provision Raises Significant Compliance Concerns.

To the extent the Commission declines the Working Group's recommendation to eliminate the pass-through provision in favor of risk management exemptions, the Working Group submits that the implementation of such provision in energy markets would create several practical concerns. Importantly, for the reasons described below, the resulting burdens and cost impacts of a pass-through provision will be disproportionately borne by those commercial firms, including energy firms, that presently manage risk through hedging practices.[35]

i. The Proposed Rule Contemplates One-for-One Hedging.

For example, the Working Group is concerned that market participants will be required to engage in a transaction-by-transaction analysis for purposes of determining whether a particular trade is in fact a *bona fide* hedge. As discussed in Part III.D, above, such an approach is inconsistent with the routine hedging practices employed by many participants in commodity markets, particularly energy markets. Specifically, these market participants determine their aggregate underlying exposures in physical markets and match hedges to those physical positions rather than hedging on a one-to-one basis.

With this in mind, the pass-through of *bona fide* hedge exemptions as contemplated in the *Proposed Rule* is unworkable as it would require hedgers claiming the use of a *bona fide* hedge exemption to match a swap that hedges or mitigates commercial risk with a specified underlying physical commodity transaction. To the extent the Commission uses its discretion to retain the pass-through of *bona fide* hedge exemptions, the Working Group suggests that the Commission maintain the approach currently used by DCMs and ECMs with significant price discovery contracts—which is to focus on market participants' overall physical exposures and match hedges to the physical position.[36]

ii. Written Trade-by-Trade Representations and Acknowledgements are not Practical in Dynamic, Fluctuating Markets.

Proposed CFTC Rule 151.5(g) requires that a party relying on the *bona fide* hedging exemption provide a written representation verifying that the particular swap qualifies as a *bona fide* hedging transaction under proposed Rule 151.5(a)(1)(iv).[37] Given the discretionary nature of new CEA Section 4a(c)(2)(B), the Working Group believes that such written representation

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[35] The Working Group submits that the *Proposed Rule* will impose costs for monitoring compliance associated with the Commission's proposed pass-through provision. *See infra* Part III.J, discussing the Commission's costs and benefit analysis.

[36] *See, e.g.,* ICE OTC Rule 1.16.

[37] Proposed CFTC Rule 151.5(g)(1) states: "The party not hedging a cash market commodity risk, *or both parties to the swap if both parties are hedging* a cash market commodity risk . . . ." The Working Group submits that if both counterparties are hedging, there is no need to pass through their respective hedge exemptions and thus fails to understand the provision as written.

should be optional, not mandatory (understanding that absent a representation, there would be no pass-through). It is impracticable to require a trader to make a determination at the time of the trade on the nature of the transaction, particularly, whether the swap is a hedge or speculative in nature.[38] Moreover, as stated above, it would be impracticable, if not impossible, for the vast majority of market participants to link hedges with specified underlying physical positions for purposes of complying with the pass-through requirements in proposed CFTC Rule 151.5(g).

iii. The Requirement that Parties Verify the Ongoing Nature of a Hedge is not Workable.

The Working Group is also concerned with proposed CFTC Rule 151.5(j)(2), which permits a party to exceed a position limit only "to the extent and in such amounts that the qualifying swap directly offsets, and continues to offset, the cash market commodity risk of a *bona fide* hedger counterparty." This provision is problematic as it implies that a hedger must monitor and track the status of a each transaction it represented to its counterparty as a *bona fide* hedge and continually inform and represent to the counterparty that such swap continues to be a *bona fide* hedge. Such requirement would result in significant and costly burdens on hedgers.

F. PROBLEMS WITH THE PROPOSED SPOT-MONTH LIMITS.

1. The Determination of Deliverable Supply Should be Fully Transparent and Subject to Public Notice and Comment.

Pursuant to proposed CFTC Rule 151.4(c), DCMs that list referenced physical delivery contracts would be required to submit estimates of deliverable supply for those physical commodities to the Commission on an annual basis. The *Proposed Rule* notes that the Commission will rely on a DCM's estimate of deliverable supply unless it "determines to rely on its own estimate." Given the overwhelming importance of the determination of deliverable supply for a Referenced Contract in establishing workable spot-month position limits under the framework set forth in the *Proposed Rule*, this process should be fully transparent,[39] and the Commission should provide public notice and permit comment by interested parties. In furtherance of this process, the Working Group suggests the following approach:

- November 30 - DCM Estimate Submissions. DCMs submit to the Commission deliverable supply estimates for each physical delivery referenced contract that is subject to a spot-month limit and listed or executed pursuant to the rules of such DCMs. This submission is immediately noticed by the Commission for public comment.

- Mid-December - Comment Deadline on DCM Estimates. Interested parties would have 15 days to submit comments to the Commission providing their views on the DCM's deliverable supply estimates.

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[38] The Commission also recognizes the difficulty in discerning between speculation and hedging. *See* End-User Exception Rule, at 80,753.

[39] The Working Group supports proposed CFTC Rule 151.4(c)(3) requiring estimates submitted by a DCM to be accompanied by a description of the methodology used by the DCM and any supporting data.

- Mid-January - CFTC Issues Proposed Position Limits. Approximately 30 days following the submission of comments on the DCM deliverable supply estimates, the Commission would publish (or post on its website) proposed position limits for each referenced contract.

- February 1 - Comment Deadline on Proposed Position Limits. Interested parties would have 15 days to submit comments on the Commission's proposed position limits for each referenced contract.

- March 1 - CFTC Issues Final Position Limits. The CFTC would release (or post on its website) final position limits for each referenced contract.

- April 1 - New Position Limits Become Effective. Affected market participants would receive approximately 30 days to come into compliance with the new position limits. The new position limits would remain in effect until March 31st of the following year.

Finally, the Working Group strongly recommends that the Commission grandfather any position put on in good faith prior to the effective date of any final position limit set by Commission rule, regulation, or order.

2. The Proposed Spot-Month Position Limits for Cash-Settled Contracts Should be Reconsidered.

i. The Working Group Respectfully Submits that the Limit for Cash-Settled Contracts Does Not Need to Equal the Limit for Physically-Settled Contracts.

In the first transitional phase, proposed CFTC Rule 151.4 would apply spot-month position limits separately for physically-delivered contracts and all cash-settled contracts, including cash-settled futures and swaps. The Commission has proposed to set the limit for cash-settled contracts at the same level as the level for physically-settled contracts, a level which is established as 25% of deliverable supply. While the Working Group notes that the establishment of identical spot-month limits for cash- and physically-settled contracts has been the practice in recent years, it respectfully submits that the practice is not grounded in a sound regulatory foundation. Cash-settled contracts have substantially different potential impacts on pricing. Although deliverable supply is an important component for establishing position limits, if any, for physically-delivered contracts, its importance is greatly diminished with respect to cash-settled contracts. The Working Group respectfully submits that the Commission reconsider this approach and establish a much higher, more appropriate spot-month limit, if any, on cash-settled contracts.

ii. As Applied to Cash-Settled Referenced Contracts, the *Proposed Rule* Significantly Reduces a Trader's Permitted Position.

The Working Group submits that such approach inappropriately cuts in half position limits on cash-settled referenced contracts. For example, a NYMEX Henry Hub Natural Gas (NG) physically-settled futures contract has a spot-month limit of 1000. As a result, NYMEX

(NN) cash-settled futures and an ICE HH LD1 swap each have a spot-month limit of 1000. By separating the spot-month limits into "physically-delivered" and cash-settled," and setting each spot-month limit at 1000, a market participant is effectively forced to add its NN position to its HH LD1 position, and whereas it previously could have held 1000 in each (2000 in total), it can now only hold 1000 cash-settled contracts in total. Such a result will likely constrict liquidity in the NYMEX NN and ICE HH LD1 markets. This is contrary to two of the express policy goals of CEA Section 4a(a): (i) ensuring sufficient market liquidity, and (ii) ensuring that the price discovery function of the underlying market is not disrupted.

Post Dodd-Frank position limits also will include swaps that previously were traded over-the-counter ("OTC") and not subject to limits. As a result, the imposition of limits on cash-settled positions will be even more constraining, as positions previously excluded from a market participant's position will now be required to be included, while the levels will be reduced in some circumstances. Thus, the Working Group respectfully requests that the Commission reconsider its spot-month position limits and modify them accordingly.

iii. Conditional Exemption for Cash-Settled Contracts Should Permit Market Participants to Hold Physically-Settled Futures Contracts.

In order to promote liquidity and efficient price discovery, proposed CFTC Rule 151.4(a)(2) provides for a conditional spot-month limit. A trader would be permitted to acquire positions that are five times the spot-month limit if such positions are exclusively in cash-settled contracts, and the trader holds physical commodity positions that are less than or equal to 25 percent of the estimated deliverable supply of a physical commodity.[40] However, to qualify for the conditional exemption, market participants may not hold any physically-settled futures contracts.

The Working Group believes the condition requiring market participants to hold no physically settling futures contract is contrary to the statutory goals of CEA Section 4a to promote transparency, protect price discovery, and ensure the efficiency of markets. To the extent a hedger wants to avail itself of the conditional spot-month limit, it would be required to move out of physically settled futures, which would reduce liquidity and price discovery in the physically settled futures markets. The Working Group is concerned that the diminution in liquidity could negatively impact price convergence in the core physical delivery contract.

Accordingly, to accommodate more appropriately the hedging needs of market participants, the Working Group suggests an approach wherein cash-settled position limits are

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[40] Specifically, the conditional exemption for cash-settled contracts would apply if (i) such positions are exclusively in cash-settled contracts, and (ii) a trader holds physical commodity positions that are less than or equal to 25 percent of the estimated deliverable supply. With regard to the second condition, a trader may not hold or control (a) positions in cash-settled contracts in the spot month that exceed the level of any single month position limit, (b) any positions in the physical delivery referenced contract based on the same commodity that is in such contract's spot month, and (c) cash or forward positions in the referenced contract's spot month in an amount that is greater than one-quarter of the deliverable supply in the referenced contract's underlying commodity. *See* proposed CFTC Rule 151.4(a)(2).

set as a multiple of physically-settled position limits, and so long as a market participant is not in violation of any position limit, their physical positions should not be limited in any manner.

3. The Commission Should Identify All Referenced Paired Contracts Subject to Spot-Month Position Limits.

Without clear guidance from the Commission, the broad and vague language defining referenced paired contracts could lead to subjective and inconsistent interpretations by market participants seeking to identify the universe of referenced paired contracts. As such, the Working Group requests that the Commission identify the universe of futures contracts, option contracts, swaps, or swaptions that constitute referenced paired contracts and provide market participants the opportunity to comment on any Commission determination. Because the Commission cannot identify uncleared contracts until they are executed, it should limit referenced paired contracts to only those that are cleared.[41]

Further, after the Commission's initial identification, the Working Group suggests that, in its process for determining whether a swap must be cleared pursuant to the Act, the Commission should also determine whether such swap constitutes a referenced paired contract. New CEA Section 4a(a)(7) provides the Commission with broad authority to exempt swaps from speculative position limits it establishes pursuant to Section 4a. If a swap is not required to be cleared pursuant to the mandatory clearing requirements of the Act, it should not be included for purposes of determining position limits.

G. THE PROPOSED POSITION VISIBILITY LEVELS WILL IMPOSE A DISPROPORTIONATE BURDEN ON HEDGERS.

Notwithstanding the absence of any mandate from the Act, the Commission proposes to establish position visibility levels for referenced contracts other than agricultural contracts,[42] and establishes reporting requirements for all traders exceeding those levels in all months or in any single month, including the spot month.[43] Traders with positions above visibility levels in these referenced contracts would be required to submit statements containing additional information about their cash market and derivatives activity, including data relating to substantially the same

[41] The Commission should not be concerned about excluding uncleared contracts because as soon as they become large or material for limit purposes, the Commission can make them subject to mandatory clearing.

[42] The core referenced futures contracts in the energy sector that are subject to position visibility levels are: NYMEX Light Sweet Crude Oil (22,500 contract level); NYMEX NY Harbor Gasoline Blendstock (7,800 contract level); NYMEX Henry Hub Natural Gas (21,000 contract level); and NYMEX NY Harbor No. 2 Heating Oil (9,900 contract level).

[43] *See* proposed CFTC Rule 151.6. The Working Group notes that the visibility limits are below, and in some cases, significantly below, the all months combined and any month position limits.

commodity (*i.e.*, commodities that are different grades or formulations of the same basic commodity).[44]

These visibility and consequent reporting requirements are unnecessary given the transparency provisions that currently exist under the CEA and those being implemented under Title VII of the Act. For example, transparency is provided under: (i) the Large Trader Reporting System for futures markets; and (ii) reporting requirements adopted under Title VII applicable to large swap traders and registered entities, including derivative clearing organizations ("DCO"); and (iii) reporting requirements of uncleared OTC transactions to SDRs or the Commission itself. Further, to the extent that the Commission seeks specific information regarding the hedge exposures of a large market participant (or group of large market participants), it can exercise its special call authority set forth in Rule 18.05 of the Commission's Regulations.[45]

Further, the *Proposed Rule* fails to address and analyze adequately the compliance costs of meeting such visibility requirements and articulate any material benefits accruing to swap or futures markets.[46] The Working Group submits that, in contrast to speculators, compliance with the proposed visibility levels will result in a substantial and disproportionate burden on *bona fide* hedgers, as hedgers will be required to produce voluminous data.

Therefore, in light of the transparency created by Title VII of the Act and the Commission's ability to request data from market participants pursuant to its existing special call authority, the Working Group submits that the imposition of position visibility levels and periodic reporting requirements for hedge exposures is unwarranted. Such requirements will unnecessarily impose a substantial compliance burden for all markets participants and would not provide any benefit that justifies the costs.

H. TRANSACTIONS BETWEEN AFFILIATES SHOULD NOT BE COUNTED FOR POSITION LIMIT COMPLIANCE PURPOSES.

Inter-affiliate transactions that merely shift risk between one corporate affiliate and another (*i.e.,* a book transfer) should not be counted for purposes of complying with position limits. Indeed, inter-affiliate swaps do not in any way enhance systemic risk, nor do they affect liquidity in swap markets. Specifically, inter-affiliate transactions do not add to concentration in the market and therefore cannot lead to an attempt by a market participant to corner the market through excessive speculation. Consequently, the Working Group submits that there is no benefit in including affiliate transactions in any position limit.

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[44] These statements must include: (i) the date the trader's position initially reached or exceeded the visibility level; (ii) gross long and gross short positions on an all-months-combined basis; (iii) the contract month and the trader's gross long and gross short positions in the relevant single month (if visibility levels are reached or exceeded in any single month); and (iv) if applicable, certification no positions subject to the additional reporting requirements set forth in the *Proposed Rule* are held.

[45] 17 C.F.R. § 18.05.

[46] *See infra* Part III.J, discussing the Commission's costs and benefit analysis.

I. AGGREGATION OF POSITIONS.

The Working Group generally supports the proposed aggregation rules and disaggregation exemption as applied to "owned" non-financial entities. However, the Working Group respectfully requests clarification on the scope and application of the indicia of independent control. Specifically, the Commission should (i) clarify the type of showing a market participant must make to demonstrate independent control; (ii) provide reasonable flexibility for market participants to address specified indicia through alternative, yet functionally equivalent, measures; and (iii) confirm that the positions of a non-financial subsidiary or affiliate that meet the applicable independent management and trading requirements will not be aggregated with a parent financial entity.

The Working Group submits that employees such as attorneys, accountants, and risk management personnel may be shared between two affiliate companies without violating the independence requirements under proposed CFTC Rule 151.7, so long as they do not actively and personally perform day-to-day trading activities and engage in day-to-day trading decisions. The Working Group further submits that risk management systems may also be shared between affiliated companies without violating the independence requirements under proposed CFTC Rule 151.7, so long as appropriate security mechanisms are in place to prevent each company from gaining access to information or data about its affiliated companies' positions, trades, or trading strategies.

Although the Working Group generally supports the proposed aggregation rules and disaggregation exception, it fails to understand certain aspects of proposed CFTC Rule 151.7(g). Specifically, subpart (g)(1)(ii) requires that, in any application for a hedging exemption, a market participant must provide an "independent assessment report" as described in proposed CFTC Rules "151.9(c)(1)(iii) and 151.9(f)(3)." The Working Group notes that these cross-references do not exist and believes this discrepancy is the result of a typographical error that should be corrected. Notwithstanding these errors, the Working Group requests that the Commission provide market participants flexibility in meeting the requirements of proposed CFTC Rule 151.7(g). Specifically, the Working Group respectfully requests that the Commission permit market participants discretion in using internal or external personnel to make assessments relating to the independence of its owned non-financial entities.

Finally, the Working Group recommends that the Commission treat the application for exemption from aggregation requirements for non-financial entities required by proposed CFTC Rule 151.7(g) as a self-certification requirement that is effective immediately upon filing. In addition, the Commission should provide a safe harbor for market participants that submit such applications in good faith to promptly correct inadvertent errors or make adjustments in an orderly manner to comply with newly implemented regulatory requirements under Title VII of the Act.[47]

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[47] Such safe harbor protection is required to permit certain market participants to communicate internally to determine how they must comply with the proposed aggregation requirements and ensure that they do not violate the Commission's proposed rules or the rules and regulations of other federal regulators with jurisdiction over their operations.

J. MEANINGFUL COMMENT ON THE ANTICIPATED COSTS AND BENEFITS OF THE PROPOSED RULE IS NOT POSSIBLE AT THIS TIME.

The Working Group respectfully submits that it cannot meaningfully respond to the costs unless a comprehensive and complete view of all Dodd-Frank rulemakings are known. In particular, the Commission has not yet issued a proposed or final rule further defining the term "swap," as set forth in new CEA Section 1a(47)(A). As such, the Working Group and other market participants are unable to ascertain the universe of transactions that may be subject to Commission oversight as "swaps" and, thus, subject to the requirements of the *Proposed Rule*. This guidance is critical to the efforts of affected market participants to identify and understand the scope and impact of the *Proposed Rule* and effectively comply with it.

The reporting requirements proposed by the Commission as discussed above are commercially impractical and if implemented would create substantial and perhaps irreparable costs to the market and market participants. Further, it is difficult, if not impractical, to meaningfully analyze the costs to traders applying for, and reporting pursuant to, the *bona fide* hedge exemption because it is unclear how the reporting obligations would fit at this time with the many other reporting requirements proposed by the Commission for market participants. Therefore, the Working Group respectfully reserves the right to comment at a later date on the costs from the *Proposed Rule*, when those costs can be better understood and quantified. However, the Working Group offers analysis on several issues regarding the Commission's discussion of costs in the *Proposed Rule*.

The *Proposed Rule's* analysis of requirements under the Paperwork Reduction Act address three main areas of costs that commercial firms can anticipate: (i) *bona fide* hedge related reporting requirements, (ii) recordkeeping requirements for traders applying for *bona fide* hedge exemptions, and (iii) costs arising from the visibility level reporting obligations. The *Proposed Rule* states that the costs related to the reporting of *bona fide* hedges are anticipated to be $37.6 million in the aggregate. This equates to $188,000 per market participant. The recordkeeping requirements for traders applying for *bona fide* hedge exemptions are anticipated to be an additional $10.4 million in the aggregate for annualized start up and capital costs and annual operating costs, which equates to $65,000 per market participant.[48] In addition, the *Proposed Rule* estimates that the costs to implement the position visibility levels is approximately $29.7 million in the aggregate, which equates to $212,000 per market participant. The costs associated with those market participants that exceed the visibility levels and need to seek a *bona fide* hedge exemption are estimated to be approximately $465,000 per market participant.

The costs set forth in the Paperwork Reduction Act analysis are not considered in the cost-benefit analysis set forth in the *Proposed Rule*. The costs outlined in the Paperwork Reduction Act section, along with the additional costs imposed by the *Proposed Rule* on *bona*

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[48] The Commission does not provide a breakdown between annualized capital and start up costs and annual total operating and maintenance costs in the discussion of costs in the Paperwork Reduction Act analysis. Therefore it is not possible to ascertain the operating and maintenance costs noted in the *Proposed Rule*, and discussed herein, which the impacted market participants can expect to bear on an annual basis.

fide hedgers, should be subject to a thorough cost-benefit analysis of any final rule issued in this proceeding. For example, should the Commission exercise its discretion and adopt the pass-through provision, additional costs not considered by the *Proposed Rule* are the costs associated with monitoring compliance with the pass-through provision set forth in proposed CFTC Rule 151.5(a)(1)(iv) that will be imposed on entities relying on the *bona fide* hedge exemption.

The *Proposed Rule* does not offer any empirical evidence as to the criteria for selecting, or process for identifying, the universe of market participants likely to be impacted by this rulemaking. For example, the Commission anticipates that on an annual basis, 140 market participants would be subject to the visibility level reporting obligations, and 200 would be subject to the reporting requirements applicable to *bona fide* hedging transactions. Given that visibility limits are to be set at a substantially lower level than the proposed position limits, the Working Group respectfully submits that it would be reasonable to assume that the number of entities impacted by the visibility limits would be greater than those which would need to seek a *bona fide* hedge exemption. However, the *Proposed Rule* espouses an opposite view.

Further, the cost estimates for wage and salary have been estimated from the Securities Industry and Financial Markets Association ("SIFMA") information. Internal data collected and analyzed by members of the Working Group suggest that the average cost per hour is approximately $120, much higher than SIFMA's $78.61, as relied upon by the Commission.[49] In addition, many commercial firms, including members of the Working Group, are not staffed with the expertise to build the systems that will be required to comply with the various reporting provisions of the *Proposed Rule*. The Working Group anticipates that its members will be utilizing the expertise of consultants to create and implement the information technology systems required by the *Proposed Rule*. Firms will be seeking these services at a time when consultants are in high demand and even before the implementation of Dodd-Frank requirements are at capacity. Thus, the cost estimates offered in the *Proposed Rule* regarding anticipated wage and salary impacts may be significantly below the costs of consultants.

IV. Open Comment Period.

Given the complexity and interconnectedness of all of the rulemakings under Title VII of the Act, and given that the Act and the rules promulgated thereunder entirely restructure OTC derivatives markets, the Working Group respectfully requests that the Commission hold open the comment period on all rules promulgated under Title VII of the Act until such time as each and every rule required to be promulgated has been proposed. Market participants will be able to consider the entire new market structure and the interconnection between all proposed rules when drafting comments on proposed rules. The resulting comprehensive comments will allow the Commission to better understand how its proposed rules will impact swap markets.

V. Conclusion.

[49] For a complete discussion regarding the Working Group's cost estimates of the CFTC's proposed rules, see the Comments of the Working Group submitted in response to the CFTC's proposed rule regarding the duties of swap dealers and MSPs, filed on January 24, 2011. *Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants*, 75 Fed. Reg. 71,397 (Nov. 23, 2010).

The Working Group supports appropriate regulation that brings transparency and stability to the energy swap markets in the United States. The Working Group appreciates this opportunity to comment and respectfully requests that the Commission consider the comments set forth herein as it develops a final rule in this proceeding.

The Working Group expressly reserves the right to supplement these comments as deemed necessary and appropriate.

If you have any questions, please contact the undersigned.

Respectfully submitted,

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