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Goldman Sachs

March 28, 2011

Via Electronic Submission
Mr. David Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Re: Proposed Federal Position Limits for Derivatives and Associated Regulations

Dear Mr. Stawick:

Goldman, Sachs & Co. ("Goldman Sachs")[1] appreciates the opportunity to provide the Commodity Futures Trading Commission (the "CFTC" or the "Commission") with comments on the proposed rules relating to position limits (the "Proposed Rules")[2] on derivatives, pursuant to Section 737 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act" or "Dodd-Frank").

I. Summary

We have significant concerns about the Proposed Rules.[3] In particular, we believe that the manner in which the Proposed Rules would apply limits to positions that are "concentrated"

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1 Goldman Sachs is a wholly-owned subsidiary of The Goldman Sachs Group, Inc. (together with affiliates, "GS Group"). GS Group is a global investment banking and securities firm that engages in investment banking, securities, investment management and other financial services primarily with institutional clients. GS Group is a financial holding company regulated by the Board of Governors of the Federal Reserve System. Through J. Aron & Company, a wholly owned subsidiary, and related affiliates, GS Group is a leading international dealer in commodities and commodity derivatives. Goldman Sachs Asset Management, L.P. is a registered commodity trading advisor, commodity pool operator and investment advisor that provides investment advisory and investment management services to a broad range of clients.

2 76 Fed. Reg. 4752 (Jan. 26, 2011), the release being referred to as the "Proposing Release."

3 We are limiting our comments to certain aspects of the Proposed Rules but note that we share the other concerns that are described in detail in letters that have been submitted to the Commission by the Futures Industry Association, Inc. (the "FIA") and the International Swaps and Derivatives Association, Inc. ("ISDA") (the letter from John M. Damgard, President, the FIA, to David Stawick, Secretary, Commodity Futures Trading Commission,

when viewed in the unduly narrow context of belonging to a swap or futures "class," without giving effect to offsets across classes, will reduce liquidity for *bona fide* hedgers and will impair the price discovery process. We do not believe that the Commission has articulated a compelling rationale as to why limiting positions in this manner would be beneficial. Accordingly, it is our view that the costs and potentially disruptive effects of the Proposed Rules outweigh their potential benefits. If the Commission determines that it is necessary to impose position limits, we respectfully urge that it modify its approach by applying limits exclusively to spot month positions in contracts that may be physically-settled. To the extent that the Commission imposes limits on both futures and swaps, we recommend that it recognize offsets between such positions.

II. Position Limits under Dodd-Frank

Controversy surrounds the question of whether the Dodd-Frank Act authorizes the Commission to establish position limits without formally finding that limits are appropriate.[4] However, as the Commission cites in the Proposing Release,[5] there is no controversy over the fact that, if position limits are established, they are to comply with a very clear four-part Congressional mandate. Section 737 of Dodd-Frank states that "[i]n establishing limits…the Commission…shall set limits to the maximum extent practicable, in its discretion

(i) to diminish, eliminate, or prevent excessive speculation…;
(ii) to deter and prevent market manipulation, squeezes and corners;
(iii) to ensure sufficient market liquidity for *bona fide* hedgers; and
(iv) to ensure that the price discovery function of the underlying market is not disrupted."

This provision reflects a careful balancing of competing interests on the part of Congress. Specifically, to the extent that the Commission establishes position limits rules, such rules are to be directed at eliminating the potential burdens associated with speculation that is excessive and at preventing manipulation. At the same time, such rules are to be structured in a way that does not undermine market liquidity or disrupt the price discovery function. Insofar as the Proposed Rules are directed at certain positions that are deemed to be "concentrated," without any evidence that they pose risks of excessive speculation or manipulation, we believe they go beyond the first two parts of this framework and, in so doing, they undermine the Commission's

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dated March 25, 2011, and the letter from Robert Pickel, Executive Vice Chairman, ISDA, to David Stawick, Secretary, Commodity Futures Trading Commission, dated March 28, 2011 (collectively, the "FIA and ISDA Letters")). We are particularly concerned about two issues described in the FIA and ISDA Letters. The first is the constraints that the Proposed Rules would place on the ability of commercial market participants to rely on the *bona fide* hedge exemption as a result of the narrow definition of the types of transactions that qualify for *bona fide* hedge treatment and the process that entities must observe in order to avail themselves of the exemption. The second are the proposed changes to the aggregation rules and, more specifically, the elimination of the long-standing independent account controller provision, which we believe will reduce market liquidity and impair the price discovery function of the commodities markets without any discernable benefit.

[4] In the Proposing Release, the Commission asserts that it was directed by Congress under Dodd-Frank to establish speculative limits and that it is not required to find that position limits are necessary to prevent unreasonable volatility or price changes. We respectfully disagree with this interpretation for the reasons set forth in detail in the FIA and ISDA Letters.

[5] 76 Fed. Reg. at 4753 and 4758.

ability to achieve the second two parts of it. To explain why this is the case, we believe it is important first to consider the structure of commodities markets.

III. Background on Commodities Markets and the Role of the Intermediary

There is no single commodities market. Rather, there are a variety of related and interdependent markets that are distinguished by commodity product, the location at which the product is delivered and the time at which such delivery occurs. Different types of entities tend to participate in particular markets based on their objectives. For example, producers of commodities for whom commodity prices are central to revenues, tend to participate in forward markets in order to lock-in future prices for budget planning purposes. Consumers of commodities, for whom commodity prices make up just one component of costs and who may have the ability to defer consumption or pass on cost increases, tend to participate in short-term markets. Speculators participate across markets when their view of supply and demand fundamentals suggests that opportunities may exist. Investors, who often participate in commodities markets through indices, tend to take positions that offset producer sales, though their participation is a small fraction of the open interest made up of producer activity.

The intermediary acts as a bridge between the various markets, resolving quantity, location, timing, product-type and other mismatches. Intermediaries buy forward from producers, sell near-term to consumers and manage the basis risks between those positions through various risk management strategies. Intermediaries tend not to take significant directional or speculative positions,[6] but provide substantial liquidity by making markets for a range of commodities, delivered at a variety of locations at various points in time. Putting credit considerations to one side, intermediaries are typically indifferent as to whether the particular transaction they execute takes the form of a futures contract listed on a designated contract market ("DCM"), or a bilateral swap, and choose instruments based on client demands and available liquidity.

As described below, we respectfully submit that the Proposed Rules will interfere with the ability of intermediaries to perform their central role across commodities markets in a manner that will undermine the availability of liquidity for commercial hedgers and the operation of the price discovery function.

IV. Proposed Rules' Focus on "Concentrated Positions"

a. The Commission's Approach and Rationale

Under the Proposed Rules, the Commission would establish position limits in two phases. In the first phase, the Commission would establish limits for 28 core referenced contracts and economically equivalent swaps for the applicable spot month period based upon existing CFTC

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[6] See Annex A, which is based on CFTC data for swap dealers. The dark line at the bottom reflects the net directional, or speculative, positions of swap dealers. The lighter line at the top shows time spread transactions entered into by swap dealers. The chart demonstrates that though swap dealers maintain very limited directional speculative positions, they maintain large spread positions to provide the bridge from a market in one period of time to a market in another period of time.

and exchange spot months. In the second phase, it would establish spot month limits based on estimated deliverable supply, and limits for each month and all months combined for referenced contracts based on an open interest formula. The Phase II limits would apply both on an aggregated basis across contracts of the same "class," and on a "class"-specific basis. For this purpose, futures and options executed on a DCM constitute one class, and cleared and uncleared swaps constitute another.

The Proposing Release indicates that having limits apply to classes is necessary to protect against positions that are "concentrated." We believe that focusing on the size of positions based on whether they involve swaps or futures without regard to the net position size is an unduly restrictive way of measuring concentration. As a consequence of the class-specific limits, an entity, such as an intermediary, that is long in the futures class and short in the swap class of the same underlying commodity could be found to violate position limits even though it may have ***no*** speculative position across markets, taken together. In the Proposing Release, the Commission provides two justifications for this result.

First, the Proposing Release quotes a study from 1926 stating, "large concentrated positions in physical commodity markets can potentially facilitate price distortions given the capacity of any market to absorb the establishment and liquidation of large positions in an orderly manner."[7] Second, the Proposing Release states that the concentration of large positions in one or a few traders may "create the unwarranted appearance of appreciable liquidity and market depth" and that trading under such conditions can "result in sudden changes to commodity prices that would otherwise not prevail if traders' positions were more evenly distributed among market participants."[8] As an illustration of the problem associated with the second point, the Proposing Release cites the infamous Hunt Brothers corner of the silver market in 1979.

The sources cited by the Commission and, of course, the Hunt Brothers episode predate the existence of a financially-settled commodity swaps market. Moreover, each relates to situations involving large positions in physical delivery contracts that were ***speculative*** if not outright ***manipulative***. Offsetting positions that are distinguished by taking the form of a future against a swap are not speculative let alone manipulative. Moreover, the Hunt Brothers situation related to manipulations involving trading in the actual physical commodity, supplies of which could be and were limited and therefore more easily manipulated.

The Commission and the exchanges have long acknowledged holders' ability to recognize offsetting positions in order to determine their own compliance with applicable positions or accountability limits. This has been true of both futures positions held against other futures and futures positions held against physical hedges. The Proposed Rules adhere to this approach and also recognize offsets of swaps against physical hedges. However, through the class limits, the Proposed Rules uniquely single out swaps and futures as being ineligible for offset treatment, even though the swaps in question are acknowledged and required by the Proposed Rule to be ***"economically equivalent"*** to the futures positions. We believe that this

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7 The Proposing Release at 4755.

8 *Ibid.*

approach is unwarranted and will have the consequences of impairing liquidity and the price discovery function.

b. The Proposed Rules' Adverse Impact on Liquidity and the Price Discovery Function

The following example demonstrates the adverse consequences of the class limits. Assume that an investor interested in establishing a long energy position purchases an energy index swap from a swap dealer ("Transaction 1"). Assume that the swap has a notional amount of $50 million and a two-year term. In order to hedge its risk, the swap dealer purchases futures contracts that correspond to the commodity index that settle in the first two nearby months ("Transaction 2"). Such a hedging strategy is a common way for the intermediary to obtain an offset by accessing the market (the nearby contracts) that has the greatest liquidity.

Assume further that a producer client then approaches the swap dealer seeking to implement a hedge in order to obtain financing for a new development that will expand energy supplies. The producer sells a three-year swap on natural gas in a notional value of $75 million to the swap dealer ("Transaction 3").

In connection with executing Transaction 3, the swap dealer liquidates the futures position acquired in Transaction 2 and puts on an additional short futures position in the nearby months as a hedge for its $25 million net residual long position. Transaction 1 serves as a hedge for Transaction 3 and the fact that Transaction 1 was in place enables the swap dealer to provide the most competitive pricing and best execution to the producer in Transaction 3.

The Proposed Rules would inhibit the willingness and—potentially—the ability of the swap dealer to enter into Transaction 1 and Transaction 2 because each of these positions, though offsetting and not speculative, would be subject to separate position limits. This would reduce the liquidity and execution efficiency that would have otherwise been available to the *bona fide* hedging producer in Transaction 3. Moreover, the price discovery process for the producer will be less robust. The bridge between the long interest of the investor and the short interest of the producer—the intermediary—would be a draw bridge with its gates up.

c. Recommended Alternative Approaches; Requested Clarifications

If the Commission concludes that it is necessary to impose limits, we believe that the most effective way to ensure that they achieve the statutory objectives of diminishing, limiting or eliminating excessive speculation and preventing manipulation without undermining liquidity or price discovery would be to apply them to physically-settled contracts in the spot month (*i.e.*, when the contracts are at or near expiration) and have them be based on deliverable supply. The proposed Phase I limits on physically-settled contracts would prevent potential imbalances at settlement by ensuring that positions held do not exceed deliverable supply as the delivery requirements come into effect. In addition to preventing potential imbalances at settlement, having spot limits for physically-settled contracts would also affect the trading of those contracts outside the spot month and of swaps that are priced with reference to such physically-settled contracts. This is because the prices of properly designed physically-settled contracts

"converge" at settlement with the prices of the physical commodities that underlie them. This phenomenon is an important means of ensuring that prices of contracts are rooted in the fundamentals of supply and demand.

Unlike spot month physical contracts, the open interest of swaps and forward futures markets is not based on or constrained by deliverable supply, as new contracts can be written for every buyer against a seller. Position limits in this unconstrained realm do not serve a discernible purpose and likely will disrupt the liquidity benefits to *bona fide* hedgers that come from having broad-based market participation. However, convergence ties the prices of such positions back to supply and demand fundamentals. Accordingly, convergence to prices of a physical market that is subject sensible spot position limits will effectively regulate all swap and forward futures contracts. Using spot month limits on physical contracts also has the benefit of reducing the monitoring burdens on the Commission and facilitating compliance by market participants.

If position limits are to be applied to swaps and/or to physical contracts outside the spot month, we believe that the Dodd-Frank mandate and the interests of the market would better be served by rules that both aggregate positions across "classes" and recognize the offsets within such aggregated positions without regard to class type. Such position limits would provide market participants with a sufficient basis to understand that the market has the capacity to absorb the establishment and liquidation of positions. Specifically, if the market understands that all participants must operate within an aggregated limit that is truly focused on directional, speculative risk, participants will know that that the true speculative interest (and risk) that is established or liquidated by position holders are within those aggregate boundaries.

The Proposed Rules would establish limits of at ten percent of the first 25,000 contracts and 2.5 percent thereafter.[9] In the event that the Commission retains class-specific limits, we recommend that the limits be set as a flat percentage of open interest of the relevant contracts, rather than a percentage that is graduated based on the size of total open interest, and that the percentage limit be established at a level that protects liquidity and price discovery.

We believe that the ***existence*** of liquidity is more important than what the Proposing Release describes as the "unwarranted ***appearance*** of liquidity" (emphasis supplied). By limiting the recognition of offsets, the Proposed Rule will impact actual liquidity as described in section b. above. Importantly, the approach of using aggregated net position limits will not eliminate position limits, but rather apply limits to those positions that are speculative. To the extent that a net directional position remains after offsetting positions in different contract classes that remaining net position would be subject to whatever position limits may be applicable.

We also recommend that to the extent any position limit is determined with reference to market open interest, the open interest be measured over a period of time sufficiently long to avoid pro-cyclical effects. Specifically, an increase in speculative activity during the observation period for a new limit would result in an expanded limit in the following period. Alternatively, if

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[9] The Proposed Rule 151.4(d)(1).

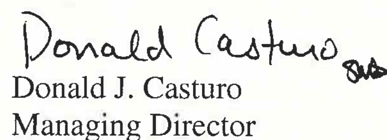
there is a lower level of activity during the relevant observation period, that would result in a new limit that may be unduly restrictive. We would recommend that the normal observation period be five years, and that any limits that are imposed in the initial phase without the benefit of five years of data be set at a level that is not unduly restrictive. Further, in order to avoid potential disruptions and the loss of legitimate transactions for market participants (including *bona fide* hedgers) we recommend that there be a mechanism that would allow positions established in reliance on an existing limit be grandfathered from liquidation requirements when new limits come into effect.

We also seek clarification from the Commission that a position in a listed futures contract on a commodity index that is offset with positions in the futures contracts that are constituents of that index will be regarded as a net position for purposes of the limits applicable to the DCM listed class of contracts. This clarification is important in light of the common market practice for index futures to be traded against the corresponding underlying futures contract, and because these trades are risk neutral, similar to offsetting positions in the same listed futures contract, for which netting treatment is available.

V. **Conclusion**

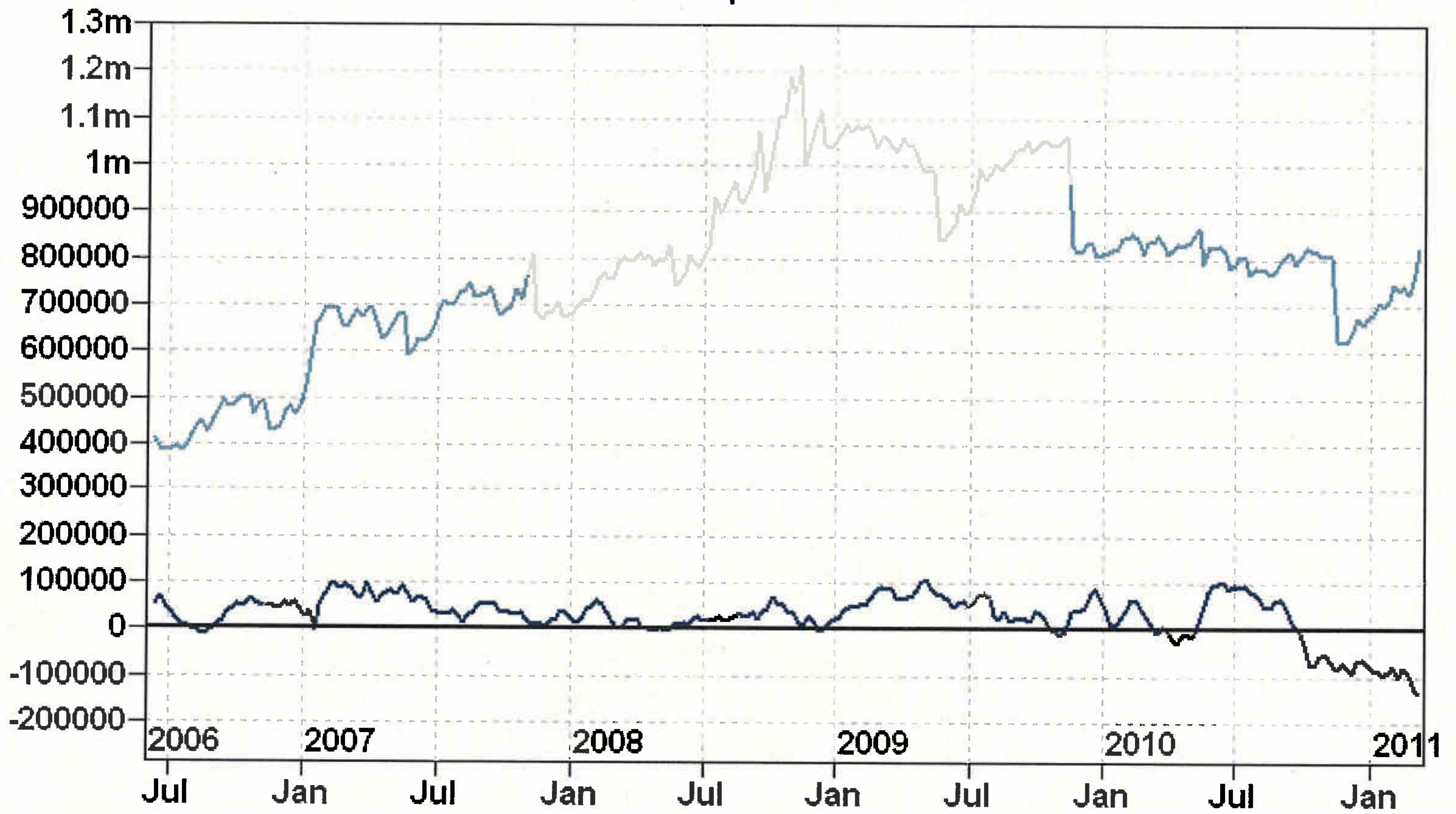
We appreciate the opportunity to comment on the Proposed Rule and would be pleased to discuss any of the comments in this letter with the Commission staff in more detail.

Respectfully yours,



Donald J. Casturo
Managing Director

Annex A



Source: CFTC Commitment of Traders Reports