March 28, 2011

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

Re: Position Limits for Derivatives," 76 *Fed. Reg*. 4752 (Jan. 26, 2011) RIN: 3038

Dear Mr. Stawick:

The Petroleum Marketers Association of America ("PMAA") is pleased to submit this letter to the Commodity Futures Trading Commission ("CFTC" or Commission") on its Notice of Proposed Rulemaking RIN 3038-AD15 and RIN-AD16 regarding Position Limits for Commodity Derivatives.

PMAA is a national federation of 48 state and regional trade associations representing over 8,000 independent petroleum marketing companies. These companies own 60,000 convenience store/gas stations and supply gasoline and diesel fuel to an additional 40,000 stores. Also, PMAA member companies sell, at retail, 90% of the heating oil consumed in the US. PMAA representatives have frequently testified before the Commission and before Congress on matters relating to the regulation of energy commodities and derivatives on energy commodities.

Also joining PMAA in these comments is the New England Fuel Institute. NEFI is a member of the Petroleum Marketers Association of America, and an independent trade association representing the home heating industry since 1950. NEFI represents approximately 1,000 home heating oil and propane retailers and related service companies, most of which are small, multi-generational family owned- and operated-businesses.

Many PMAA and NEFI member companies have been utilizing energy derivatives markets for their hedging needs for decades in an attempt to protect customers from volatility and price spikes in energy derivatives markets. Therefore it is in the interest of these companies and their consumers that these markets are as transparent, stable and functional as possible, and we appreciate the opportunity to provide the Commission with input on this matter.

Introduction

Section 737 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") requires the CFTC to establish within 180 days of its enactment speculative position limits for commodities that had been exempt under the Commodity Exchange Act.[1] These "exempt commodities" include energy-related commodities (i.e., crude oil, gasoline, natural gas and heating oil) as well as metals. PMAA and NEFI are strongly supportive of the immediate implementation of position limits. Therefore, we share the concerns expressed by Commissioner Chilton regarding delayed implementation or an extended phase-in period for adoption of position limits that required by Dodd-Frank.

Commissioner Chilton…

> "I have said repeatedly that it is of paramount importance to adhere to the deadlines imposed by Congress in the Wall Street Reform and Consumer Protection Act of 2010. Position limits is one of the rulemakings with an earlier target date. The current proposal does not meet the statutory time limits of imposition of limits within 180 days from the date of enactment for energy and metal commodities and 270 days for agricultural commodities. The agency does not have the authority to delay these statutory deadlines.
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> At the open Commission meeting of the agency on December 9, 2010, the Chairman indicated an intent to move forward with two proposals on speculative position limits and to move ''expeditiously'' to implement spot month limits. This bifurcation of spot and single month/aggregate rulemakings was a good attempt to meet the January deadline set by Congress. At the meeting on December 16, 2010, however, the Commission was presented with a single proposed rule, with a 60-day comment period, addressing spot, single month, and aggregate limits. Accordingly, it is now clear that spot month limits will not be implemented for many months, at best, and single month/aggregate limits and the corresponding new bona fide hedging rule may take more than a year to implement."[2]

PMAA and NEFI believe that excessive speculation contributed to the 2007-2008 crude run-up and the subsequent fall out, and that it is contributing to the current surge in crude oil and refined petroleum prices. According to data recently released by the Commission, speculators have raised their positions in energy markets by 64% compared to June 2008, bringing speculation to the highest level on record. PMAA and NEFI believe that establishing appropriate and meaningful speculative position limits is essential in establishing the proper price functioning of the energy derivative markets. PMAA and NEFI recognize the Commission has worked diligently to draft, propose and prepare for implementation numerous interrelated rules.

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[1] 180 days after enactment was January 17, 2011. PMAA and NEFI are disappointed in the delay in implementing position limits for exempt commodities.

[2] Statement of Commissioner Chilton Federal Register / Vol. 76, No. 17 / Wednesday, January 26, 2011 / Proposed Rules

The timeline of implementation is of concern as we have expressed above. Following please find our comments on the standards proposed in the rule.

In general, PMAA and NEFI:

1. Support the Commission's immediate adoption of spot month speculative position limits;
2. Do not object to delaying implementation of non-spot month position limits; however, urge their implementation at the earliest possible date;
3. Believe the limits for spot and non-spot months are insufficient in meeting Congressional intent of the Act to prevent excessive speculation;
4. Urge the Commission to adopt effective back month levels that will accomplish the legislative purpose of curbing excessive speculation;
5. Urge the Commission to adopt single month limits that are lower than the all-months combined levels;
6. Urge the Commission immediately to adopt a position accountability regime for the non-spot months in place of its proposed position visibility rule;
7. Urges the Commission to adopt lower speculative position limits for passive, long-only traders;
8. Urge more frequent, periodic review of limits by the Commission and emergency meetings should be called for in certain conditions;
9. Urge a narrow *Bona Fide* Hedging Definition that does not include financial interests of swap dealers.
10. Question the intentions of the Commission it the creation of a 125% conditional spot month cash-settled contract limit;
11. Question the intention of the Commission in the establishment of "Legacy Limits" for certain agricultural contracts, and further question whether or not such limits are appropriate for referenced energy contracts; and
12. Support the new account aggregation language that will help to insure that all accounts and positions that should be made subject to class and aggregate limits are captured.

I. Position Limits – Congressional Intent

It is well established that the CFTC's primary statutory mandate is to foster fair, open and efficient functioning of the commodity markets as a hedging and price discovery tool for bona-fide physical hedgers. PMAA and NEFI believe that the proposed position limits are critical to fulfilling this mandate and thereby protecting market users and the public from undue burdens

that may result from ‘‘excessive speculation.’’ Section 737 of the Dodd-Frank Act is a clear expression by the Congress that "excessive speculation" is bad for the markets, market participants, American consumers and the welfare of the broader economy.

The Dodd-Frank Act acknowledges the potential harm of excessive speculation and has reaffirmed the importance of position limits by providing the Commission with expanded authority to impose such limits on trading that occurs on regulated markets, on currently unregulated markets and in the aggregate across all markets. Congress has declared that sudden or unreasonable price fluctuations attributable to ‘‘excessive speculation’’ create an ‘‘undue and unnecessary burden’’ on interstate commerce and directed that the Commission shall establish limits on the amounts of positions which may be held as it finds necessary to ‘‘diminish, eliminate, or prevent’’ such burden. New section 4a (a) (3) of the Act expressly directs the Commission to set such limits at levels that would serve, to the maximum extent practicable, in its discretion:

> (i) To diminish, eliminate, or prevent excessive speculation as described under this section;
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> (ii) To deter and prevent market manipulation, squeezes, and corners;
>
> (iii) To ensure sufficient market liquidity for bona fide hedgers; and
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> (iv) To ensure that the price discovery function of the underlying market is not disrupted and to establish position limits for Swap Dealers.

Section 737 of the Dodd-Frank requires the CFTC to strengthen position limits to cover all derivatives markets. Section 737 emphatically provides that the Commission "shall by rule, regulation, or order establish limits on the amount of positions, as appropriate, other than bona fide hedge positions that may be held by any person[.]" The Commission is required to establish position limits as Congress intentionally used the word, "shall," to impose the mandatory obligation.

Legislative history clearly establishes Congressional intent requiring the CFTC to adopt strong and effective position limits. This is evidenced by the fact that the word, "shall," replaced the word "may" in the House version of the Dodd-Frank Act, then titled, "The Wall Street Reform and Consumer Protection Act of 2009." In particular, when the House version of the bill was introduced on December 2, 2009, Section 3113 on Position Limits stated: "The Commission may, by rule or regulation, establish limits (including related hedge exemption provisions) on the aggregate number or amount of positions in contracts based upon the same underlying commodity (as defined by the Commission) that may be held by any person, including any group or class of traders [.]"[3]

However, when the House passed the bill on December 11, 2009, the word, "may" was replaced with "shall" pursuant to the former House Agriculture Committee Chairman Collin Peterson's amendment. During the floor debate, Congressman Peterson said "the amendment

[3] Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010), §737

strengthens confidence in trader position limits on physically deliverable commodities as a way to prevent excessive speculative trading." In doing so, he has indicated that it is his intention to strengthen the position limits by imposing on the Commission the mandatory obligation to adopt strong position limits. This amendment has been incorporated into the bill, was retained by the Senate, survived the conference negotiations, and was eventually enacted into law.

The plain reading of §737 reveals that the phrase "as appropriate" modifies only those position limits mandated to be imposed by the Commission, and as was determined by CFTC General Counsel Dan Berkovitz.[4] It does not modify the heavily emphasized mandate that there "shall" be position limits. The emphasis of certain commenters in opposition to the creation of position limits argues contrary to the plain language of the statute and its legislation history that the Commission shall determine "as appropriate" formulae for mandated position limits. In short, they want to put the word "may" back into the statute when that discretionary language was expressly removed by the 111th Congress.

Moreover, they read into the phrase "as appropriate" that the Commission can impose position limits only after the Commission "conduct[s] a complete analysis of the swap market data." Not only does this interpretation run contrary to legislative intent, it also contradicts other sections of the Dodd-Frank Act for the following two reasons.

First, Dodd-Frank *requires* the Commission to set limits to, diminish, eliminate, or prevent excessive speculation and to deter and prevent market manipulation, squeezes, and corners. In other words, the purpose of position limits is not to punish past wrongdoing, but rather to deter and prevent potential future dysfunctions in the commodity staples derivatives markets and to prevent harm to market participants and burdens on interstate commerce. Because the purpose of position limits is to prevent future violations, the Commission should not be required to appreciate the complete and precise level of excessive speculation prior to taking action. With he passage of Dodd-Frank that the Commission now has broad authority to collect data in the swaps markets.

Second, a close reading of the legislative intent reveals that the Commission is *not required* to conduct a thorough study of the possible effects of the position limits prior to adopting its final rule on position limits. Rather, Section 719 of the Dodd-Frank Act specifically requires the Commission "to conduct a study of the effects of the position limits *imposed* pursuant to the other provisions of this title on excessive speculation and on the movement of transactions." The Commission is required to submit the report "within 12 months *after the imposition of position limits* pursuant to the other provisions of this title."

II. Proposed Rules

The proposed rules would impose spot month, single-month, and all-months combined speculative position limits on specified physical commodity futures and options contracts ("referenced futures contracts") and physical commodity swaps that are economically equivalent

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[4] Statements by General Counsel Dan Berkovitz, Eighth Meeting on Proposed Rules Under the Dodd-Frank Act, Commodity Futures Trading Commission, December 16, 2010, Washington, DC.

to such contracts (together, "referenced contracts"). The spot month position limits would apply separately to physically delivered and cash-settled contracts, respectively, meaning that traders could have up to the spot month position limit in both the physically delivered and cash settled contracts (unless the cash settled contract positions are held pursuant to the "conditional-spot month position limit").

The Commission is proposing to impose non-spot speculative position limits for referenced contracts to single-months and to all-months-combined. The Commission is proposing to determine non-spot month limits by using a formula based on open interest. It would recalculate the speculative position limits annually. The aggregate all-months-combined and single-month position limits, found in Proposed Rule § 151.4(d)(1), would each be equal to 10% of the first 25,000 contracts of the "average all-months-combined aggregated open interest," with a marginal increase of 2.5% of the open interest for amounts above 25,000 contracts.

The speculative position limits would apply separately to each contract class that is to listed futures and options and to OTC swaps, and to both classes on an aggregate basis.

The Commission is delaying implementing back month limits on the basis that it does not now have sufficient data to establish the limits using the formula that it is adopting. The Commission chooses not to adopt an alternative method of determining speculative position limits as an interim solution. Instead, the Commission has delayed its determination of such limits until the Commission receives data regarding the levels of open interest in the swap markets.

As an interim step, however, the Commission proposes under its reporting authority under Section 4t of the Act to require traders above a "position visibility" trigger level to report on their physical and derivatives portfolios in the referenced commodity. The data received would enable the Commission to analyze the nature of the largest 20-30 traders' positions in a market. This position visibility rule is strictly a reporting requirement and will not constrain traders' excessive speculative trading.

III. PMAA/NEFI Comments on the Proposed Rules

a. <u>In General</u>

PMAA and NEFI support the Commission's proposal to immediate implement speculative position limits for the spot months as mandated by the Dodd-Frank Act. PMAA and NEFI encourage the Commission to achieve Congress' direction to take steps to prevent manipulation and to reduce excessive speculation by adopting a position accountability regime, rather than a mere position visibility rule. As discussed below, "position accountability" rules, or "soft limits" would more closely adhere to the Congressional directive to adopt speculative position limits on a shortened time schedule and its implementation is not dependent upon open interest data.

PMAA and NEFI believe that the proposed formula for determining both spot-month and non-spot month position limits does not adequately address all four goals of speculative position limits as mandated by the Dodd-Frank Act. By strengthening the proposed limit formulae for

spot month, single-month and aggregate month transactions, the CFTC will better fulfill Congressional intent and the CFTC's stated mission.

First, the spot-month limit of 25 percent of open interest is far too generous. The Commission must consider lowering the stated limit to a level that is more consistent with existing limits referenced agricultural commodities (to which the Commission is proposing to maintain under "Legacy Limits") or that are more reflective of existing accountability limits for referenced energy contracts on Designated Contract Markets.

Second, instead of relying on an open interests based formula for determining position limits, we believe that the Commission should determine an acceptable aggregate level of speculation and set individual trader limits to be reflective of that aggregate level. Moreover, the Commission is proposing to *raise* the individual month limit to the same level as the all-months level. This will exacerbate the problem of excessive speculative trading in the nearby futures month, the month upon which energy prices are determined. If the Commission does not adopt levels for speculative position limits that are more likely to be effective, it should at a minimum consider implementing a "position accountability regime" rather than a "visibility regime" and do so on a permanent basis in order to provide an additional tool with which to address aberrational market conditions.

And finally, the Commission should consider setting separate, lower position limits for passive long traders (*i.e.*, index funds, exchange traded funds, and other similar vehicles that generally buy without regard to price), and should require that positions of passive long speculators who follow the same trading strategy be aggregated for purposes of applying the position limits. In moving forward with a phased approach for implementing position limits, the Commission needs to assess all of its data requirements and to assure that necessary data to support full analysis of speculative position limit issues will be available to the Commission. It is particularly important that adequate data be obtained to analyze issues related to passive long trading strategies.

b. The Proposed Speculative Position Limits Should be Strengthened

i. The non-spot month position limits would be so high as to be ineffective

PMAA and NEFI are concerned that the non-spot month position limits that would result from the proposed rules would be so high as to be ineffective. The Commission acknowledges that the proposed framework sets high position levels. These levels are equivalent to the largest positions held by market participants[5]. PMAA and NEFI believe the proposed position limits fail to address the overall impact of speculators on the futures, options and swaps markets. Position limits that only target very large positions intended to manipulate the market do not address the problem of the cumulative effect of a large number of speculators with significant positions. Moreover, as discussed further below, the proposed rules do not in any way address the growing issue of passive long traders.

[5] See Proposal *at* 4762.

PMAA and NEFI also believe that the determination of "estimated deliverable supply" should immediately be withdrawn from the Designated Contract Markets and that the CFTC should retain exclusive discretion in determining "deliverable supply" for the purposes of establishing speculative position limits. When determining "deliverable supply" and when formulating limits, the Commission should consult with and solicit information from market experts, including appropriate governmental entities (i.e., the Department of Energy's Energy Information Administration and the U.S. Department of Agriculture) and academics, as well as representatives of industries that produce, refine, process, store, transport, market and consume the underlying commodity.

ii. The Commodity Exchange Act as amended by the Dodd-Frank Act requires more stringent position limits

Section 4a(3) of the Act, as amended by the Dodd-Frank Act, explicitly sets forth the factors that the Commission should apply in setting speculative position limits The Dodd-Frank Act makes clear that the goals of speculative position limits are broader than restraining the market power of the very largest speculative traders. Section 4a(3) as amended by the Dodd-Frank Act instructs that speculative position limits, to the maximum extent practicable, should achieve four goals:

1. diminish, eliminate or prevent excessive speculation;
2. deter market manipulation;
3. ensure liquidity for bona fide hedgers; and
4. ensure that price discovery is not interrupted[6].

Importantly, Congress amended section 4a(3) of the Act to clearly state that deterring manipulation and diminishing excessive speculation are distinct goals of speculative position limits In addition, Congress has required that speculative position limits be set to ensure liquidity for bona fide hedgers and to ensure the well-functioning of price discovery.

The Commission in the Proposal recites that the limits it is proposing meet the four goals, but this position is contradicted by the Commission's admission that the formula yields ". . .

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[6] Section 4a(3) provides that:

> In establishing the limits required in paragraph (2), the Commission, as appropriate, shall set limits—
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> (A) on the number of positions that may be held by any person for the spot month, each other month, and the aggregate number of positions that may be held by any person for all months; and
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> (B) to the maximum extent practicable, in its discretion—
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> (i) to diminish, eliminate, or prevent excessive speculation as described under this section;
>
> (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.

limits that are purposely designed to be high in order to ensure sufficient liquidity for bona fide hedgers but in fact will do little to curb passive speculation that drives price volatility.

In this regard, we note that in Delta Airlines Comment letter regarding the 2010 Proposed Rules on Speculative Position Limits (Apr. 26, 2010) pointed out that in 2000, the percentage of hedging open interest to speculative open interest in the oil market was estimated to have been approximately 61% hedgers to 39% speculators. During the 2000 to 2003 time period, which is the period immediately prior to the unprecedented run-up in speculative trading, the market functioned well and was orderly. There is no evidence of insufficient liquidity for hedgers during this period. In contrast, it is estimated that by 2009 the percentage of hedging open interest to speculative open interest essentially reversed, although the amount of hedging open interest stayed relatively constant.

iii. The open interest-based formula was derived in the context of smaller agricultural markets

The open interest-based formula was derived in 1992 in the context of trading in the agricultural markets. It was implemented during a time when open interest in the applicable markets was far lower than in today's energy markets. As a consequence of applying the same formula no matter how large the open interest in a market grows, a single trader will be able to amass ever larger absolute positions. As the Commission itself noted, however, it is universally observed that ". . . the size of the largest individual positions in a market do not continue to grow in proportion with increases in the overall open interest of the market." Nevertheless, the Commission's proposed speculative position limit levels assume the same marginal rate of growth in the size of such individual positions no matter how large open interest becomes. PMAA and NEFI believe that, if the Commission wants to be true to the spirit of the formula approach, the Commission should reconsider whether in light of the recent influx of speculative traders, the formula should be revised so that the proposed 2.5% marginal increase rate is progressively reduced as levels of open interest rise. Using the current formula permits increasingly large absolute position sizes under the speculative position limits. Permitting such large absolute positions to be traded is contrary to the Congressional instruction to curtail excessive speculation.

iv. The Commission has other precedents for how to set speculative position limits

The traditional method of setting speculative position limits employed by the Commission relied upon an analysis of the distribution of traders and the size of their positions. This approach looked at the actual size of positions by trader and set the limits to constrain the largest positions based on the distribution. When first implementing the open interest-based formula approach, the Commission noted that it was comfortable with the results of applying the formula based on its experience with the size of the position limits derived therefrom based on its surveillance experience. Recent experience with the energy markets suggests that the traditional method of setting speculative position limits would be superior to the open interest-based formula approach, given the changes that have occurred in the markets. At a minimum the Commission should use such data to inform how high the absolute size of positions which are permitted when applying the open interest test.

v. As an alternative to the open interest-based formula approach, the Commission should determine an acceptable level of aggregate speculation and set individual trader limits to be reflective of that aggregate limit

At the proposed position limit levels, individual speculators could continue to enter the market with very large positions and cumulatively impact the market. Instead, individual speculative position limits should be calculated with the aim of ensuring that the proportion of hedging open interest to speculative open interest in the market equals the ratio that existed during a period when the markets were functioning orderly.

The problem that needs to be addressed is not simply manipulation where one trader may possess too much market power. Rather, the problem is the cumulative effect of a large number of speculative traders who hold large but not dominant positions.[7] The answer to the problem is for the Commission to determine an acceptable total level of speculation (that is, not excessive), which is most easily stated as a percentage of open interest.

Delta Air Lines, Inc. offered an illustrative methodology for this calculation in its advance comment letter filed with the CFTC.[8] The basic concept is that speculative activity above the amount necessary to provide market liquidity for the trading of bona fide hedgers and to provide for efficient price discovery is, by definition, excessive. Specifically, for the oil futures market, the period between 2000 and 2003 is identified as the most recent period during which the futures market operated in an orderly manner. During this "base period," in the case of the oil futures market, hedgers constituted approximately 60% of the market open interest and speculators constituted the remaining approximately 40%. Delta Air Lines, Inc. recommends establishing a "Speculative Open Interest Target" on an annual basis by looking at the immediately preceding year's hedging open interest and calculating the amount of speculative open interest that would be necessary to maintain the same ratio between hedging and speculative trading as existed during the base period. The speculative position limit level that applies to individual traders would then be set at a level intended in very rough terms to maintain this ratio of speculative to bona fide hedging trading, thus meeting the four criteria of the Dodd-Frank Act. PMAA and NEFI endorse Delta Air Lines suggested methodology.

[7] *See* Testimony of Michael W. Masters, Masters Capital Management, LLC, before the Committee on Homeland Security And Governmental Affairs, United States Senate (Jun. 24, 2008) *available at* http://hsgac.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=4b570baa-713f-45a3-9c42-794c93ff5a41- (noting that the commodities futures markets are now dominated by speculators and that many bona fide physical hedgers, now greatly outnumbered and having to transact in a market that is mainly driven by the activities of large institutional speculators, are questioning the value of the futures markets for hedging purposes).

[8] Advance comment letter from Delta Air Lines, Inc. (Dec. 13, 2010) *at* 8-14, *available at* http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission26_121310-1.pdf

vi. Position limits derived from an aggregate "Speculative Open Interest Target" could be phased in gradually

The Commission should implement the position limits in phases, over a time period determined by the Commission, while observing the impact of the new limits to avoid any unintended consequences. Using such a phased approach would provide the Commission with an opportunity to make corrections if it observed any adverse market effects from using a new methodology.

c. The Commission Is Proposing the Same Limit for Individual Months and All-Months Combined

PMAA and NEFI believe that the proposed non-spot month position limits are problematic because, by setting the single month limit at the same level as the all-months limit, they create the potential for a trader to concentrate a large portion of its speculative interest in a single month. This is potentially of great concern because of the importance of trading in a single month to setting the cash price for energy contracts.

Many existing speculative position limits limit the outright size of a position in any one month at a level less than the all-months combined limit. The Commission has proposed to eliminate the inter-month spread exemption and to set the single month level at the same level as the all-months combined level. To the extent that this has the potential for resulting in traders having a larger footprint in the market, the Commission should reconsider this proposal. The Commission should also reconsider this proposal taking into consideration the role and trading patterns of passive, long only traders. The Commission should not raise the single month limit until it determines the activity and effect of passive long traders in this delivery month.

Further, PMAA and NEFI believe that the Commission should apply a step down with respect to the next to delivery month position limit (*i.e.*, restrict the amount of speculative positions that traders can hold in the next to delivery month to a level that is less than the single-month position limit but larger than the spot month position limit). The concept of imposing progressively higher position limits from the spot month to the back months is well established. Note that, in addition to the stepped structure for limits currently reflected in Rule 150.2 with respect to enumerated agricultural contracts,[9] CBOT, for example, provides for stepped-down position limits in the last five days of the expiring futures month in the case of rough rice futures contracts.[10]

d. The Commission Is Proposing to Maintain "Legacy Limits" in Agricultural Commodities

For the agricultural futures contracts enumerated in current Rule 150.2, the Commission is proposing legacy limits that would retain the all-months combined limits for such contracts and would make the single-month limits equal to the all-months-combined limits. The

9 17 C.F.R. § 150.2

10 *See* CBOT Rule 5 "Interpretations & Special Notices Relating to Chapter 5."

Commission has not explained why it is retaining such limits and the benefits of retaining the presumably lower legacy limits. Clearly it should do so, and should consider whether the lower legacy limits would better achieve the Congressional goal for speculative position limits in the exempt commodities, as well.

e. Passive Long Speculators Should Be Subject To Separate, Lower Position Limits Than Active Speculative Traders

i. *Passive long speculation obstructs price discovery and increases volatility in the futures market*

PMAA and NEFI consistently has expressed concern about the impact of passive investments in crude oil through vehicles such as index funds, exchange traded funds and notes, mutual and sovereign wealth funds and other similar vehicles. Such funds and investment vehicles share a common characteristic that interferes with and distorts the normal functioning of the futures markets - *they buy without regard to current supply and demand fundamentals and thus without regard to price*. Their trading strategies are premised on factors unrelated to the physical market, but in executing them, they compete with physical commodity consumers and producers and, in turn, distort the market and make hedging more uncertain and, consequently, expensive. In short, their presence upsets the price discovery function.[11]

There is ample evidence that passive - or long - investment began to surge in 2006, peaked in mid-2008, plummeted in the second half of 2008, and then began to rise again in early 2009. In the early to mid-2000s, financial institutions began receiving permission to create and market new kinds of securities linked to commodities and commodity indexes.[12] These included indexes based partly, or predominantly, on energy and energy derivatives. By 2006, the SEC

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[11] Commissioner Bart Chilton's remarks from this past November echo this view. He stated "Within the last several years . . . markets have changed because, for one, speculators have changed. More and more, the new speculators have used futures markets as an asset class. . . . Many of the new speculators also have a distinguishable trading pattern, at least during many times. . . . They have a known speculative trading strategy and many times, they are gigantic. I call them 'Massive Passives' because of their size and their trading strategy, which for the most part is, not all the time but for the most part, price insensitive. . . . The Massive Passives' size and trading strategy are fairly new to these markets, and many (myself included) think they can have an aberrant impact on markets. Other market participants trade around the Massive Passives, for example. These market participants know what the Massive Passives are going to do, so they make their own decisions based upon the Massive Passive trading strategy, which again is to simply "go long," most of the time. . . . Consumers can pay more than they should because of the Massive Passives. That's simply not right. For example, take crude oil in 2008. Crude went to the highest levels ever, $147.27 a barrel that June. Gasoline prices topped $4.00 a gallon in most states. Some people had to make a decision between food for their families and fuel for their cars or trucks. At that time, crude oil experienced some of the highest supplies and lowest demand in history, yet prices skyrocketed. Princeton and Rice universities and others conducted studies, which suggested these speculators had some impact on pushing prices. At certain times, the Massive Passives have become fortuitous bullies in these markets because they are so very large and have such a known trading strategy. What that means is that the primary goal of futures markets, which is not only to allow for hedging of business risks but to find the true price-price discovery-is harder to get to than it has been for over a hundred years." Bart Chilton, Commissioner, Speech at the University of Notre Dame (Nov. 1, 2010) *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/opachilton-34.html.

[12] *See, e.g.*, streetTRACKS Gold Trust, SEC No-Action Letter, SEC No-Act. LEXIS 860 (Nov. 17, 2004) *available at* http://www.sec.gov/divisions/marketreg/mr-noaction/stgr111704.htm.

had approved the first exchange-traded fund that was based exclusively on energy derivatives.[13] These and other commodity-based funds -- which are heavily weighted toward energy futures -- have been aggressively marketed as a way for investors to diversify portfolios and speculate on rising commodity prices.[14]

As a result, these funds have grown exponentially. The total value of investment in commodity indexes has increased tenfold since 2003, from an estimated $15 billion to around $200 billion in mid-2008.[15] As of March 11, 2011, the net assets of a single fund consisting solely of NYMEX and ICE April and May crude oil futures contracts were valued at the astonishing sum of $1,726,401,242.17.[16] Moreover, from 2003 to 2008, the volume of oil futures traded on the exchanges quadrupled. In 2008, nearly 12 times the actual world consumption of oil traded daily on U.S. exchanges, and that level of activity was maintained in 2009. This increase in speculative activity is closely correlated with the increased volatility of oil prices, which has caused so much harm. Thus, the explosive growth of passive investment vehicles has overwhelmed the markets with a flood of money that caused sharp increases in price that were not related to demand for actual, physical petroleum.[17] That this speculative trading contributed to the parallel volatility of crude prices cannot seriously be disputed.

The Commission should (and is empowered to) address the distortive market impact of passive long speculation. Although the Commission has not previously distinguished types of speculative trading strategies in setting speculative position limits, Section 4a of the Act empowers the Commission to do so. Section 4a provides that, "Nothing in this section shall be construed to prohibit the Commission from fixing different trading or position limits for different commodities, markets, futures . . . or different trading limits for buying and selling operations . . . ."

ii. The Commission should consider specific separate, lower speculative position limits for passive long traders in the referenced contracts

The Commission should consider setting separate speculative position limits specifically for passive long traders in the referenced contracts, and should consider setting those limits to be lower than the limits that apply to active speculative traders. If the Commission is of the view that it does not have sufficient information on which to act in response to the issue of the role, effect and mitigation of the effect of passive long traders, it should commit to conducting a study to analyze and determine appropriate position limit levels for passive long traders. In light of the importance of this issue, the Commission should commit to completing the study within a time

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13 *See* United States Oil Fund, LP, SEC No-Action Letter, SEC No-Act. LEXIS 422 (Apr. 10, 2006).

14 *See* "Excessive Speculation in the Wheat Market" *supra* note 18, *at* 5.

15 *Id.*

16 Daily holdings of United States Oil Fund, LP are disclosed at http://www.unitedstatesoilfund.com/uso-holdings.php).

17 Because NYMEX had repealed hard position limits in 2001 in favor of accountability rules (which as the Commission notes, are not enforced), there were no effective checks on the inevitable price spikes and volatility.

period to be determined by the Commission during the next six months. It is clear that this issue is likely to remain an important one for the overall functioning of the futures market.

We also notes that, as a result of the Dodd-Frank Act, the Commission has enhanced authority to craft a reporting program designed to provide information about passive long traders. We believe that, in adopting the Dodd-Frank Act, Congress expected that the Commission will use its enhanced authority to aggressively address the issues facing the futures market.

And finally, we question the Commission's decision to create separate "conditional spot month position limits" for certain cash-settled contracts under Section 151.4(a)(2) that is five times the spot month limit (or, 125 percent of deliverable supply) if the trader does not have a hedge exemption, if the positions are held exclusively in cash-settled contracts and if the trader holds physical commodity positions that are less than or equal to 25 percent of deliverable supply. We worry that such conditional spot-month limits could apply to passive investors (i.e., index funds) and therefore used as an evasion of more stringent spot-month limits.

iii. Positions of passive long speculators should be aggregated to the extent the positions are held or controlled by passive long speculators who follow the same trading strategies

Further, positions of passive long speculators should be aggregated to the extent the positions are held or controlled by passive long speculators who follow the same trading strategies. Proposed Rule § 151.7(d) would require any trader that holds or controls the trading of positions multiple accounts or pools with identical trading strategies to aggregate all such positions. The Proposal explains that this would prevent circumvention of the aggregation requirements by, for example, a trader seeking a large long only position in a given commodity through specific positions in multiple pools. The proposed requirements should be strengthened to ensure that multiple accounts or pools with identical trading strategies be aggregated regardless of whether their positions are held or controlled by the same trader to shield the futures markets from the cumulative impact of multiple passive long speculators who follow the same trading strategies.

iv. Exchange-Traded Funds and Index Funds are not "Bona Fide" Hedgers and should have limits imposed retroactively on their positions.

PMAA and NEFI are concerned that financial institutions, especially exchange-traded funds and index funds, will continue to pursue interpretative measures of exemptions under the proposed rule in order to qualify for the hedge exemption. We are specifically concerned that the proposed rule Section 151.5(a)(1)(ii), which affords an exemption to position limits for positions that are taken for the "reduction of risks in the conduct and management of a commercial enterprise" may be too broadly and could be exploited. Further, the Commission should examine whether or not the proposed hedge exemption may be exploited by financial institutions, including hedge funds, index funds and other speculators, simply by securing or leasing the right physical storage capacity.

Further, PMAA and NEFI oppose the grandfathering of positions held by passive investors as provided under Section 151.9 of the proposed rule. Immediately upon enactment of

the proposed rule, such positions should be made retroactively subject to speculative position limits. Additionally, the CFTC should rescind all rights to *bona fide* hedge exemptions and to disaggregation exemptions as provided under Section 151.7 (f) and (g) for passive investors.

f. <u>Position Visibility Requirements Should Be Strengthened by Imposing Position Accountability Rules</u>

i. "Position accountability" rules would impose a "conditional" limit set at a level lower than the level established by the "hard" limit derived from the Commission's open interest-based formula

The Commission's proposed position visibility rules should be enhanced to include a prophylactic surveillance function similar to that of exchange "position accountability" rules. Position accountability rules impose "soft limits" on traders. There are two types of limits imposed by position accountability rules—one type of limit includes the ability of the exchange to obtain additional information from a trader above the triggering limit, and the second type of limit provides that the trader must consent to an order of the exchange not to increase the trader's position upon order of the exchange.

To the extent the Commission is delaying setting speculative position limits in the back months due to lack of information on how to complete the open interest-based formula, there is no reason that the Commission could not adopt position accountability rules under its speculative position limit authorities. Position accountability rules would impose a "conditional" limit set at a level lower than the level established by the "hard" limit derived from the Commission's open interest-based formula. The "conditional" limit would not be dependent upon application of the open interest-based formula, so it could be set immediately, and could remain in place after the open interest-based formula is implemented as well.

The Commission could impose position accountability rules providing that, upon reaching the triggering level, a trader must provide additional information on its positions to the Commission and consent to refrain from further increasing its position upon instruction of the Commission, as delegated to the Commission's staff. The Commission could direct traders not to increase positions*, e.g.,* in market conditions where the market has increased or decreased more than 10% over the course of year, in cases where the particular trader constitutes a systemic risk, or in other instances of market instability as defined by the Commission.

ii. Position accountability rules would set "soft" position limits at more reasonable levels than the "hard" limits proposed based on the open interest-based formula, and would be responsive to the Congressional directive to implement speculative position limits on an aggressive timetable

Imposing position accountability requirements have the benefit of setting an intermediate "soft" limit at more reasonable levels than the "hard" limits proposed based on the open interest-based formula. The requirements would not constrain large traders in orderly markets, but would be available to constrain speculative traders as appropriate when market conditions warrant. The outright speculative position limit or "hard" cap would remain as an outer bound on all

speculative positions. Imposing position accountability requirements is responsive to the Congressional directive to implement speculative position limits on an aggressive timetable, and would provide a test solution to two problems—the lack of data currently and the fact that the "hard" limits imposed by the open interest-based formula are at the very outer bounds of effectiveness.

g. Bona Fide Hedging Activities Should Not Include Financial Interests of Swap Dealers.

Although the Commission's proposal to adopt a *bona fide* hedging exemption for traders hedging commercial risks to the extent of their demonstrated needs[18] merits support, the Commission must impose a strict standard for granting such an exemption. In particular, the Commission should not exclude swap dealers' financial risk management transactions from proposed position limits, which essentially give the Too Big to Fail banks a license to keep their casinos open to wealthy investors with no benefit (and indeed great liability) to the American consumer.

In the proposed rules, the Commission relies on a definition from regulation 1.3(z), under which bona fide hedging includes "transactions or positions [that] normally represent a substitute for transactions to be made or positions to be taken at a later time *in a physical marketing channel*, and where they are economically appropriate to the reduction of risks in the conduct and management of a *commercial enterprise*."[19] However, the Commission has adopted some of the biggest swap dealers' and futures exchanges' arguments and provided exemptions for "products and services similar to [risk management products offered by swap dealers] to qualify as bona fide hedging transactions or positions."[20] This would permit swap dealers to continue "to manage the risk of a swap portfolio (*i.e.*, their casino like function of allowing wealthy investors to bet on the upward price of commodity staples) that exists at the time of implementation of the proposed regulations."[21] This approach would completely undermine the primary purpose of the proposed position limits.

h. Aggregation of Accounts

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[18] Proposed Regulation 17 C.F.R. §151.3(a)(1).

[19] *See id*., at n.49 (citing 17 CFR 1.3(z)(1)) (emphasis added).

[20] Comment Letter by Colin Bryce, Managing Director, Head of EMEA Sales & Trading, Global Co-Head of Commodities, Morgan Stanley and Simon T.W. Greenshields, Managing Director, Global Co-Head Commodities, Morgan Stanley to David Stawick, Secretary, Commodities Futures Trading Commission, April 25, 2010.

[21] Proposed Rules, *supra* note 1, at 4763.

PMAA and NEFI support the Commissions proposed aggregation standards in § 151.7 which will establish account aggregation standards specifically for positions in referenced contracts. We believe that the Commission has proposed and appropriate standard which would apply to all positions in accounts in which any trader, directly or indirectly, has an ownership or equity interest of 10 percent or greater or, by power of attorney or otherwise, controls trading. The Commission proposed rule appropriately modifies existing Part 150 to insure that pool participant's aggregate positions, with limited exemptions, to insure the Commission will have sufficient information to perform its market surveillance responsibility. PMAA and NEFI support the proposed aggregation standards in this rule.

i. Foreign Boards of Trade

PMAA and NEFI support proposed § 151.8 of the Commission's rule requiring inclusion in a trader's aggregate position limit those referenced contracts executed on, or pursuant to the rules of, a foreign board of trade. The Commission's market surveillance activities will be appropriately enhanced by this provision.

j. Annual, Periodic and Emergency Review of Limits

Section 151.4(h) of the proposed rule requires annual review of position limits on January 31st of each year, with the revised position limits being imposed on the following March 1st. PMAA and NEFI believe that more frequent, periodic review would be preferable, such as every six months. Additionally, the proposed rule is absent any "emergency review" language that would enable the CFTC to address inadequacies in existing speculative position limits or related formulae in the event of supply disruptions, market disturbances or extreme volatility, periods of inadequate liquidity or excessive speculation, or disruptions to price discovery, or as requested by the *bona fide* commercial hedger community.

Conclusion

PMAA and NEFI have significant concerns with a market structure that seemingly no longer serves a valid price discovery function. Massive positions held by speculators have contributed to price volatility that is simply unrelated to supply and demand fundamentals. The commodity markets were created to serve bona fide commercial hedgers as a tool for risk mitigation and to serve a price discovery function that is reflective of real-world supply and demand fundamentals. There is substantial evidence that deregulation and massive positions held by speculators have distorted these markets. Speculation helped to fuel the energy price hikes of 2008, which helped fuel the recession that began in that year.

Volatility induced by excessive speculation translates into higher hedging costs for product acquisition. The 111th Congress, in the Dodd-Frank Act, has acknowledged the potential harm of excessive speculation and has reaffirmed the importance of position limits by providing the Commission with new authorities to impose such limits on currently unregulated markets.

Commodities are vital resources to American industries, businesses and consumers. Well functioning markets are critical to commodity price discovery. Position limits will play a critical role in reestablishing market fundamentals.

Commissioners Michael Dunn and Scott O'Malia have previously expressed concerns that they have not seen any studies which prove excessive speculation causes higher oil futures markets beyond empirical or anecdotal evidence. Yet, PMAA and NEFI have dozens of studies which analyzed the 2008 oil price run-up and argued that money flows into the market did have an impact on oil prices. This hurts consumers and businesses alike.

OIL SPECULATION STUDIES

- Massachusetts Institute of Technology (MIT) Center for Energy and Environment Policy Research; *"The Oil Price Really Is A Speculative Bubble,"* September 2008
- Rice University's Baker Institute for Public Policy, *"Who is in the Oil Futures Market and How Has It Changed?"* August 2009
- The Peterson Institute for International Economics; *"The 2008 Oil Price "Bubble,"* August 2009
- Princeton University; *"Index Investing and the Financialization of Commodities,"* September 2009

PMAA and NEFI believe it is of great importance that the CFTC precede in establishing position limits for designated contract market (DCM) physical commodity futures contracts and swaps that are economically equivalent to such contracts. We believe that this rule will provide the data and establish reporting requirements the purpose of which will be to provide a solid empirical foundation for setting effective position limits on heretofore unregulated activities.

PMAA and NEFI support this initiative of the Commission as a crucial step toward implementing effective regulations of the commodity and futures markets, yet urge the Commission to address inadequacies in the proposed rule discussed in these comments.

We appreciate the opportunity to comment on the proposed rules.

Respectfully submitted,

Dan Gilligan, PMAA President

Howard Peterson, NEFI Chairman