CME Group

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March 28, 2011

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

Re: Position Limits for Derivatives

Dear Mr. Stawick:

CME Group[1] respectfully submits the following comments on the Commodity Futures Trading Commission's ("Commission") Notice of Proposed Rulemaking entitled "Position Limits for Derivatives," which would impose federal speculative position limits on certain contracts in agricultural and exempt commodities (the "Release").[2]

CME Group supports and shares the Commission's mission to combat price manipulation and other disruptions to the integrity of commodity prices. Such misconduct destroys public confidence in the integrity of our markets and harms the acknowledged public interest in legitimate price discovery. However, as CME Group and other commenters have pointed out in previous letters, speculation is not manipulation, nor is it an abusive practice. Far from it. Speculation is indisputably essential to the orderly functioning of futures markets; it provides market liquidity which promotes more effective commodity price discovery and allows for the efficient transfer of price risk. In Section 3(a) of the Commodity Exchange Act ("CEA"), Congress itself has found that speculators serve the national public interest by "assuming price risks, discovering prices, or disseminating pricing information" through trading in "liquid, fair and financially secure trading facilities."

The Commission's statutory responsibility and challenge therefore is not to restrict speculation per se, but to act only when "necessary to prevent" "excessive speculation" from burdening interstate commerce through what the CEA calls "unreasonable" and "unwarranted" fluctuations in the price of a commodity. *See* CEA § 4a(a)(1). To this end, the CEA sets up a two-pronged approach for imposing limits on

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[1] For the record, CME Group is the holding company for four separate Exchanges, including the Chicago Mercantile Exchange Inc. ("CME"), the Board of Trade of the City of Chicago, Inc. ("CBOT"), the New York Mercantile Exchange, Inc. ("NYMEX"), and the Commodity Exchange, Inc. ("COMEX") (collectively, the "CME Group Exchanges" or "Exchanges"). The CME Group Exchanges offer the widest range of benchmark products available across all major asset classes, including futures and options on futures based on interest rates, equity indexes, foreign exchange, energy, metals, agricultural commodities, and alternative investment products. Moreover, the Exchanges serve the hedging, risk management, and trading needs of our global customer base by facilitating transactions through CME Globex® electronic trading platform, our open outcry trading facilities in New York and Chicago, and privately negotiated transactions. CME Clearing is one of the largest central counterparty clearing services in the world; it provides clearing and settlement services for exchange-traded contracts and over-the-counter ("OTC") derivatives contracts through CME ClearPort®. The CME ClearPort® service mitigates counterparty credit risks, provides transparency to OTC transactions, and brings to bear the exchange's market surveillance monitoring tools.

[2] In addition to our substantive comments on the Commission's proposal, we have compiled a list of technical comments on the proposal which can be found in the Appendix of this letter.

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speculative positions. First, the Commission must "find" that position limits are "necessary" – a directive that Congress reaffirmed in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). CEA § 4a(a)(1). Second, once the Commission makes the "necessary" finding, it must establish a position limit regime only "as appropriate" – a statutory requirement added by Dodd-Frank. *See* CEA §§ 4a(a)(2)(A) & 4a(a)(3).

In its position limits proposal, the Commission has not met its burden of showing that the proposed position limit regime is "necessary" and "appropriate." The Commission, moreover, has failed to undertake a comprehensive cost-benefit analysis of its proposed rules, as required by statute. The Commission also ignores the wealth of empirical evidence supporting the view that the proposed hard position limits (and related aggregation policy and restrictive exemptions) would actually be counterproductive by decreasing liquidity in the CFTC-regulated markets which, in turn, would likely increase both price volatility and the cost of hedging especially in deferred months. For these reasons, CME Group opposes the adoption of the Commission's proposal.

CME Group also opposes the proposal because it contains a significant loophole which the Commission thus far has ignored. Specifically, the proposed federal limits will create an incentive for investors that are looking for commodity exposure to participate in physical commodity-based exchange-traded funds ("ETFs") because ETFs are not subject to the position limits proposal. Instead of establishing derivatives positions, such funds use investment proceeds to buy and hold physical commodities, thereby affecting the normal supply and demand dynamic for a given commodity. By encouraging this ETF activity, the Commission's proposal could lead to the very price aberrations that the Commission is attempting to prevent.

Our comments will focus on why the Commission's proposed position limit regime is not (and has not been shown to be) "necessary" and "appropriate." We also discuss the ETF loophole in the Commission's proposal and the potential negative consequences flowing therefrom, and suggest alternative ways to accomplish the shared goal of employing effective market surveillance to deter price manipulation and other abusive practices. In particular, CME Group encourages the Commission to consider using aggregate position accountability levels, rather than hard position limits, to address its market-wide surveillance concerns. Our comments conclude by highlighting the areas in the proposal where the Commission has left unaddressed significant issues by not explaining or providing a rationale for its proposal or failing to discuss the proposal's implications. Consequently, as proposed, the Release precludes the meaningful, informed public comment that the Administrative Procedure Act ("APA") requires.

I. THE COMMISSION MAY NOT PROMULGATE POSITION LIMITS BECAUSE IT HAS NOT FOUND THAT LIMITS ARE "NECESSARY".

A. <u>The Commodity Exchange Act Requires the Commission to "Find" That Position Limits Are "Necessary" Before Imposing Such Limits.</u>

Section 4a(a)(1) of the CEA provides, in pertinent part:

> For the purpose of diminishing, eliminating, or preventing such burden [of unwarranted or unreasonable price fluctuations resulting from excessive speculation], the Commission shall . . . fix such limits on the amount of trading which may be done or positions which may be held . . . *as the Commission finds are necessary to diminish, eliminate, or prevent such burden.* (emphasis added)

By its terms, Section 4a requires that, before promulgating any position limits, the Commission first "find" that the limits "are necessary to diminish, eliminate, or prevent" burdensome excessive speculation. Indeed, the CFTC's general counsel, Dan Berkowitz, confirmed that Section 4a(a)(1) sets forth a conditional mandate during the CFTC's July 2009 hearings on position limits. In response to Chairman

Gensler's question, "What does the word 'shall' mean in 4a?" Berkowitz replied, "*If* the Commission finds that position limits are necessary to prevent, diminish, or eliminate such burdens, *then* there is a directive that it shall establish position limits." Transcript of July 28, 2009 CFTC Hearing on Energy Position Limits at 70-71 (emphasis added). This interpretation is consistent not only with the quoted statutory text – which has remained essentially unchanged since 1936 – but also with Supreme Court precedent on analogous statutes.

In *Young v. Community Nutrition Institute*, the Supreme Court addressed a similar statute with respect to the Food and Drug Administration ("FDA"). In that case, a statute directed that the Secretary of Health and Human Services "shall promulgate regulations limiting the quantity [of poisonous or deleterious substances] therein or thereon to such extent as he finds necessary for the protection of public health." *Young*, 476 U.S. 974, 977 (1986). The FDA interpreted this statute as authorizing it to promulgate regulations as it found necessary, not requiring a limiting regulation for each substance. The Supreme Court agreed with the FDA and refused to read the "find necessary" clause out of the statute.

Contrary to the *Young* precedent, the Commission here has rejected the statutory precondition to the exercise of its position limit authority, stating in its release:

> The Commission is not required to find that an undue burden on interstate commerce resulting from excessive speculation exists or . . . make an affirmative finding that position limits are necessary to prevent sudden or unreasonable fluctuations or unwarranted changes in prices or otherwise necessary for market protection. Rather, the Commission may impose position limits . . . based on its *reasonable judgment* that such limits are necessary. 76 Fed. Reg. 4752, 4754 (Jan. 26, 2011). (emphasis added)

The Commission's interpretation of CEA Section 4a(a)(1) would render the "as the Commission finds are necessary" language a nullity, effectively replacing it with statutory language imposing a lower threshold that is found elsewhere in the CEA.

For instance, throughout the CEA, Congress has specified a number of areas where the Commission may exercise its judgment to promulgate rules that are *reasonably necessary*.[3] *See* CEA § 4c(6) (permitting the Commission to "make and promulgate such rules and regulations as, in the judgment of the Commission, are reasonably necessary to prohibit the trading practices described in paragraph (5) and any other trading practice that is disruptive of fair and equitable trading"); CEA § 8a(5) (permitting the Commission to "make and promulgate such rules and regulations as, in the judgment of the Commission, are reasonably necessary"). Similarly, in other areas, the CEA permits the Commission to act when it finds action "necessary or appropriate in the public interest." *See, e.g.*, CEA § 4n(a)(1) (permitting the Commission to "prescribe [questions for CPO/CTA registration forms] as necessary or appropriate in the public interest").

Under the Commission's interpretation, these three different standards – "as the Commission finds are necessary," "in the judgment of the Commission, are reasonably necessary," and "prescribe . . . as necessary or appropriate" – are all different names for the same thing. This position is untenable. It is a longstanding canon of statutory construction that "where Congress includes particular language in one section of a statute but omits it in another . . . , it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion." *Keene Corp. v. United States*, 508 U.S. 200, 208 (1993) (quoting *Russello v. United States*, 464 U.S. 16, 23 (1983)). An agency may not rewrite its statute to accommodate a regulatory spirit or to correct what it perceives as flaws in its statute. *See Landstar Express Am., Inc. v Fed. Maritime Comm'n*, 569 F.3d 493, 500 (D.C. Cir. 2009); *Bd. of Governors of Fed. Reserve Sys. v. Dimension Fin. Corp.,* 474 U.S. 361, 374 (U.S. 1986). The Commission is therefore bound by the law as written and may not act contrary to Congress' expressed intent. *See Bd. of*

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[3] Even this standard appears to be more stringent than the "reasonable judgment" standard the Commission has purportedly employed in proposing its position limit rules. *See* 76 Fed. Reg. at 4754.

Governors, 474 U.S. at 368 ("The traditional deference courts pay to agency interpretation is not to be applied to alter the clearly expressed intent of Congress.").

As written, the statute unequivocally calls for the Commission to "find" that its proposed position limits are "necessary" to "diminish, eliminate, or prevent" a burden on interstate commerce resulting from excessive speculation. *See MBH Commodity Advisors, Inc. v. CFTC*, 250 F.3d 1052, 1061 (noting that CEA § 17(i), which includes the language "if the Commission finds that," "requires that the CFTC make certain findings of fact"). Unless the Commission reconsiders its statutory interpretation and makes the finding of necessity that the statute requires, it cannot exercise its position limit authority in compliance with CEA Section 4a.

B. The Commission Has No Basis for Finding That Its Proposed Position Limits Are Necessary.

1. *Neither Credible Studies Nor the Proposal Reflects Substantial Evidence of a Link Between "Excessive Speculation" and Price Volatility.*

If the Commission had properly interpreted the statute and recognized its obligation to make a finding that limits on speculative positions are "necessary," it would not have been able to support such a finding. As CME Group highlighted in its response to the Commission's January 2010 energy position limits proposal, there is virtually unanimous academic agreement that commodity price changes have been driven by fundamental market conditions, not by speculation. *See* CME Group Comments, 10-002 Comment CL-02714, at 17-24 (Apr. 26, 2010) ("CME Comments").[4] This conclusion is seconded by the Government Accountability Office ("GAO"), which could not identify a causal relationship between speculation in the futures markets and changes in commodity prices. *See* GAO, GAO-09-285R, Issues Involving the Use of the Futures Markets to Invest in Commodity Indexes at 5 (Jan. 30, 2009). The Organisation for Economic Cooperation and Development recently collected a number of studies, noting that the bulk of the studies have found little evidence of a connection between speculation and commodity price movements, and that those studies finding any link are subject to a number of important criticisms. *See* S.H. Irwin & D.R. Sanders, "The Impact of Index and Swap Funds on Commodity Futures Markets: Preliminary Results," *OECD Food, Agriculture and Fisheries Working Papers*, No. 27, OECD Publishing (2010). The European Commission agrees that "the heart of" price volatility arises from "a series of changes in global supply and demand patterns as well as short term shocks in key commodity and raw material markets." *See* Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: Tackling the Challenges in Commodity Markets and on Raw Materials at 2 (Feb. 25, 2011). Indeed, even CFTC reports have shown that market supply and demand factors were largely responsible for shifts in oil prices in 2008 and that speculators serve as an important source of market liquidity. *See, e.g.*, CFTC Interagency Task Force on Commodity Markets, Interim Report on Crude Oil at 3-4 (July 22, 2008), http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/itfinterimreportoncrudeoil0708.pdf.[5]

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[4] In addition to the academic materials cited in our April 2010 comments, other recent academic studies confirm that there is no credible evidence of any relation between speculation (or, in some studies, commodity index investing) and price volatility. *See, e.g.*, Hans R. Stoll & Robert E. Whaley, Commodity Index Investing and Commodity Futures Prices, J. of Applied Fin., Issue 1 (2010); Bahattin Buyuksahin & Jeffrey H. Harris, The Role of Speculators in the Crude Oil Futures Market (July 16, 2009), *available at* http://ssrn.com/abstract=1435042; Celso Brunetti & Bahattin Buyuksahin, Is Speculation Destabilizing? (Apr. 22, 2009), *available at* http://ssrn.com/abstract=1393524; George M. Korniotis, Does Speculation Affect Spot Price Levels? The Case of Metals with and without Futures Markets, Finance and Economics Discussion Series, Division of Research & Statistics and Monetary Affairs, Federal Reserve Board (2009).

[5] All of the studies cited in this comment letter will be submitted to the Commission in a separate comment by CME Group.

Most recently, CFTC Commissioner Michael Dunn acknowledged that the causal connection between speculation and price volatility is unproven. In his Opening Statement for the Commission's January 13, 2011 Public Meeting, he observed that, "Price volatility exists in markets that have position limits and in markets that do not have position limits. Price volatility exists in markets that have substantial participation from index funds and markets that do not have any index fund participation whatsoever." Commissioner Dunn continued, highlighting the dearth of concrete evidence linking speculation to price volatility and stating his concern that "at best, position limits are a cure for a disease that does not exist or at worst, a placebo for one that does."[6] *See* Commissioner Michael V. Dunn, Opening Statement, Open Meeting on Ninth Series of Proposed Rulemakings Under the Dodd-Frank Act (Jan. 13, 2011) ("Dunn Opening Statement"), http://www.cftc.gov/PressRoom/SpeechesTestimony/dunnstatement011311. html.

In support of the purported link between speculation and price volatility, the Commission relies on only one economic study. It was prepared in 1926 by the Federal Trade Commission. *See* 76 Fed. Reg. at 4754 n.14. Much has changed in our country, in the markets, and in regulation of the markets since the Roaring Twenties; it is remarkable that the Commission would propose a change in public policy of this magnitude based solely on an 85-year-old report, particularly where modern studies have provided overwhelming evidence to the contrary.

To the extent there are any legitimate concerns with the potential for excessive speculation to cause unwarranted or unreasonable price fluctuations at some point in the future, CME Group believes that futures exchanges effectively address such concerns. DCM Core Principle 5 – which Dodd-Frank specifically preserved – requires exchanges to "adopt for each contract . . . as is necessary and appropriate, position limitations or position accountability for speculators" in order to "reduce the potential threat of market manipulation or congestion." *See* CEA § 5(d)(5) CME Group provided a detailed account of how futures exchanges have complied with their obligations under Core Principle 5 in its April 26, 2010 comments. *See* CME Comments at 8-12. Briefly stated, exchanges have established position limits as warranted by the characteristics of their traded contracts, and employ position accountability levels as appropriate given particular market constructs and market conditions.[7]

This flexible regulatory approach employed by exchanges is a much more appropriate and effective means of addressing potentially manipulative or disruptive positions than are blunt instruments like federal position limits that fail to account for variability in specific contract months, market conditions, and market participation. The existing exchange programs are and have been proven to be effective.[8] Therefore, CME Group believes the Commission lacks the statutory basis for establishing new federal position limits as it has proposed. Again, the absence of any effort by the Commission to show why the

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[6] We do not understand Commissioner Dunn or other cited studies to suggest that establishing a speculative position in futures has no immediate impact on price. Establishing *any* futures position – whether hedging or speculative – is part of the continuing stream of information that affects market dynamics, including price. The question is whether large speculative futures positions have been found to create artificial or abnormal lasting price effects. The CFTC cites no study since 1926 that would answer that question "yes."

[7] Swap execution facilities ("SEFs") have a parallel core principle. *See* CEA § 5h(f)(6) ("POSITION LIMITS OR ACCOUNTABILITY.—(A) IN GENERAL.—To reduce the potential threat of market manipulation or congestion, especially during trading in the delivery month, a swap execution facility that is a trading facility shall adopt for each of the contracts of the facility, as is necessary and appropriate, position limitations or position accountability for speculators.")

[8] The Commission's own recitation of the evolution of its position limits policy confirms this fact. *See* CFTC Staff Report on Commodity Swap Dealers & Index Traders at 52-56 (Appendix E) (Sept. 2008) (referring to CFTC staff study that recommended that "where limits are necessary, the exchanges should set and review the limits subject to Commission approval" because "exchanges have the necessary competence and knowledge of the particular commodity to establish the limits.") (internal citations omitted).

proposed limits are "necessary" and "appropriate" as the statute requires confirms that the Commission has no empirical or evidentiary support for its proposal.

CME Group acknowledges that the Commission may have inter-exchange or cross-market surveillance concerns that exchanges are not always able to address. But accountability rules are a more effective, scalpel-like tool for monitoring the trading activities of market participants than are hard limits. We agree with other commenters that the Commission should consider imposing aggregate accountability levels where multiple trading platforms exist for a commodity. *See* Futures Industry Association Comments, 10-002 Comment CL-02687, at 5 (Mar. 18, 2010) ("FIA Comments"); Craig Pirrong, Comment 27433, ¶ 15 (Jan. 24, 2011) ("[A]ccountability level-type systems can identify large positions thereby permitting a more detailed determination of whether a holder of such a position is a single entity, or a levered entity, or especially a single levered entity that would pose . . . [a] disorderly liquidation threat . . . . Based on such information, it would be possible for the [C]ommission, or a self-regulatory entity operating subject to the Commission's regulations, to take action targeted to the actual threat posed – if any.").

In concept, the Commission's proposed position visibility levels could serve as federal aggregate position accountability levels and allow the Commission to obtain, when warranted, such additional information as it may require to ascertain the nature of large traders' positions and to respond accordingly to any potential threat to market integrity. With the advent of swap data repositories and OTC position reporting, the Commission will already have significantly greater visibility with respect to aggregate large trader positions.

As proposed, however, the Commission's position visibility regulations would impose onerous, unwarranted, and, in many respects, redundant reporting burdens on market participants carrying positions substantially below the proposed position limit levels. Additionally, a bona fide hedger carrying a position in excess of the limits would be required to file information regarding its cash commodity and swap activity each day the position remains in excess of the limit as well as the first day after the trader's position falls below the limit. The Commission itself estimates the costs of these additional reporting requirements to market participants to be tens of millions of dollars in the referenced energy and metals contracts alone, in addition to the costs to the Commission to collect, analyze, and enforce such reporting. Rather than adopt its position visibility proposal, the Commission should require participants holding positions above a defined accountability threshold to provide, upon Commission request, such information as the Commission may require regarding the nature of their position. By limiting such requests to those targeted circumstances in which the Commission has a market surveillance concern, the Commission would achieve its objective much more efficiently, without imposing substantial unnecessary costs on market participants and taxpayers.

We would support appropriately constructed regulations implementing federal aggregate position accountability levels in lieu of position limits as a more effective and efficient means of achieving the Commission's objectives. Until such accountability levels are implemented, and shown not to be adequate, the Commission's statutory burden of finding that position limits are "necessary" before imposing such limits becomes even more difficult to meet.

2. *The Proposed Position Limits Cannot Be "Necessary" Because Their Effects Will Be Contrary to Dodd-Frank's Purposes.*

By statute, the Commission may only impose position limits on swaps "traded on or subject to the rules of a designated contract market or a swap execution facility" or swaps "perform[ing] or affect[ing] a significant price discovery function." *See* CEA § 4a(a)(1).[9] The Commission proposes to apply position

[9] The Commission suggests its proposed limits apply to uncleared swaps. *See* 76 Fed. Reg. at 4759. By statute, the Commission may impose limits on uncleared swaps only if they are traded on a DCM or SEF, or perform or affect a significant price discovery function with respect to regulated entities ("significant price discovery swaps").

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limits to a particular subset of the first category of swaps – i.e. swaps traded on or subject to the rules of a DCM or SEF that are also "economically equivalent" to DCM futures and options contracts.[10] However, the Commission fails to recognize that in imposing limits on certain types of swaps (i.e. those within its statutory position limit authority), it will encourage market participants to enter into bespoke, uncleared, non-DCM or SEF-traded swaps. The shift of trading into over-the-counter swaps with counterparty credit risk will create *more* systemic risk – a result that is both contrary to the goals of Dodd-Frank and ironic given the Commission's position that federal uniform position limits should help to address systemic risk. 76 Fed. Reg. at 4755.

In addition, the Commission's position limits proposal will create an incentive to use other instruments providing comparable exposure that lie outside of the Commission's position limit powers, including contracts offered in foreign jurisdictions and physical commodity ETFs, or to take positions in the physical commodity itself. Such shifts in trading will potentially distort supply and demand fundamentals and the flow of commodities for commercial purposes, which could lead to actual "sudden," "unreasonable," or "unwarranted" commodity prices that the Commission seeks to prevent through its proposal. Such shifts in trading also will impair liquidity in the core price discovery markets, thereby reducing risk management effectiveness and compromising transparency. These results are clearly contrary to the goals of both Dodd-Frank and the Commission.

Therefore, far from being "necessary," position limits would appear to do more harm than good based on Congress's objectives in Dodd-Frank and the Commission's own public interest pronouncements.

II. THE PROPOSED POSITION LIMIT REGIME IS NOT "APPROPRIATE" AS REQUIRED BY STATUTE.

New CEA Section 4a(a)(2) reaffirms that the Commission must set position limits "in accordance with the standards set forth in [4a(a)(1)]," which include the requisite "necessary" finding. Section 4a(a)(2) further provides that any position limit regime found to be "necessary" may only be established "as appropriate." As the following sections demonstrate, the proposed position limit framework is not "appropriate" both in terms of its timing and its key features (i.e. types of limits, recalculation methodology, aggregation policy, and exemptions).

A. The Proposal to Impose Spot-Month Limits "Expeditiously" Is Inappropriate Given the Lack of Data on Swap Markets and Swap Positions.

The Commission's proposal calls for setting federal speculative position limits in two phases. First, the Commission proposes to "relatively expeditiously" adopt spot-month limits at levels currently set by DCMs based on deliverable supply. 76 Fed. Reg. at 4753. Second, the Commission proposes to establish non-spot-month limits (i.e. single-month and all-months-combined limits) only after it has collected positional data on physical commodity swaps – a process that is expected to *begin* no earlier than the third quarter of 2011. *Id.* The Commission explains that a time lag is necessary for the non-spot-month limits because those limits would be a function of open interest and "the Commission does not currently have open interest and market structure data [regarding swaps]." *Id.*

The Commission's rationale for delaying the imposition of non-spot-month limits due to the lack of positional data on swap markets applies with equal force to the proposed spot-month limits. Although those limits are not calculated using open interest levels, they are still intended to cover swaps, specifically those that are economically equivalent to a core referenced futures contract. *See id.* at 4757;

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[10] The Commission states that it intends to propose in a subsequent notice of rulemaking a process by which significant price discovery swaps can be identified. 76 Fed. Reg. at 4753 n.8.

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see also id. ("Proposed [regulation] 151.4 would apply spot-month position limits separately for physically-delivered contracts and all cash-settled contracts, including cash-settled futures *and swaps*.") (emphasis added). Thus, as Congressional representatives have acknowledged, the "appropriateness" of all position limits – not just non-spot-month limits – hinges on the "adequacy of information about OTC markets." *See* Statement of Representative Jerry Moran during Hearing of General Farm Commodities and Risk Management Subcommittee of House Agriculture Committee (Dec. 15, 2010).

The Commission claims that spot-month limits may be adopted now because they are "based upon available information." 76 Fed. Reg. at 4753. The information available to the Commission today, however, is incomplete and will not be complete until the Commission receives reports and data on economically equivalent swaps. Until the Commission has received and analyzed all available data on economically equivalent swaps in the spot month, it cannot meet its statutory obligations to act concurrently and simultaneously to adopt limits covering futures and economically equivalent swaps.[11] To ensure that it sets and can properly monitor and enforce "appropriate" position limits, the Commission should defer *both* spot-month and non-spot-month limits until it has gathered and analyzed the necessary data on physical commodity swaps and has fully established an effective and efficient position reporting mechanism for these instruments.

Existing DCM market surveillance, position accountability rules, *and* spot-month position limits collectively address any risk to the public should the Commission wait for all appropriate data before acting. In any event, as Commissioner Jill Sommers recognized, "without data on swap market positions, the spot month limits we are proposing are not enforceable." *See* Commissioner Jill E. Sommers, Opening Statement, Open Meeting on Ninth Series of Proposed Rulemakings Under the Dodd-Frank Act (Jan. 13, 2011), http://www.cftc.gov/PressRoom/SpeechesTestimony/sommersstatement011311.html. There is simply no reason for the Commission to act hastily before it has received and considered all of the relevant information.

B. The Proposed Position Limit Regime's Key Features Are Inappropriate Because They Do Not Serve the Goals Identified by Congress.

Under Dodd-Frank, the Commission is required to take into account several factors to establish position limits "as appropriate." New CEA Section 4a(a)(3) provides that, to the "maximum extent practicable," the Commission should use its discretion to set limits to: (i) diminish, eliminate, or prevent "excessive speculation;" (ii) deter and prevent market manipulation, squeezes, and corners, (iii) ensure sufficient market liquidity for bona fide hedgers; *and* (iv) ensure that the price discovery function of the underlying market is not disrupted. Additionally, new CEA Section 4a(a)(2)(C) states that, in establishing limits, the Commission must act to avoid shifting the price discovery function to foreign boards of trade ("FBOTs").

While Congress required the Commission to develop position limits that would achieve these goals and considerations to the "maximum extent practicable," the Commission's sole focus in proposing its position limit regime appears to be preventing excessive speculation. As the following sections demonstrate, the Commission's failure to give due weight to each statutorily mandated factor has resulted in an inappropriate position limit framework – one that would not even further the Commission's cited objective of preventing excessive speculation causing unreasonable or unwarranted price fluctuations.

1. *Spot-Month Position Limits.*

a) The Proposed Deliverable Supply Formula Sets Artificially Low Spot-Month Limits by Excluding Portions of the Deliverable Supply.

[11] *See* CEA § 4a(a)(5)(b). As footnote 8 of the Commission's proposal confirms, the Commission's proposed position limits for futures and economically equivalent swaps are required to be adopted "at the same time." 76 Fed. Reg at 4753 n.8.

As proposed, spot-month limits would be set at 25% of estimated deliverable supply for the referenced contract's underlying commodity. The estimate would include supplies that are available through standard marketing channels at market prices prevailing in the spot month. The estimate would not include supplies procured at unreasonably high prices or diverted from non-standard locations or supply committed for long-term agreements.

CME Group disagrees with the Commission's proposed exclusion of supply committed for long-term agreements from the deliverable supply formula (76 Fed. Reg. at 4758) because, in the physical market, parties who maintain long-term agreements regularly make such supplies available to the market. For the product to be available to the physical market at-large, only one of the parties to the long-term agreement must perform that action. Typically, the action is performed by an intermediary party, such as a gatherer in the petroleum industry. In such instance, the gatherer may have constructed long-term agreements with producers/suppliers and can make the commodity available to the spot market in the normal course. In addition, end-users may enter into a long-term agreement with a producer/supplier or even an intermediary and place such procured commodities back into the physical spot markets for economic reasons either by direct sale or through exchange. An example of this is in the crude oil market in the US where many varied streams of crude are available with slightly different chemical construction as well as physical origin. In the usual course, end users will "optimize" their slate of feedstock by exchanging one crude stream for another with a specific counterparty or by simply selling the long-term material into the spot market and acquiring an alternate stream at what they believe is a favorable market price.

The Commission is assuming incorrectly that commodities subject to a long-term commitment are certain to be consumed and will be unavailable for resale into commercial channels at the delivery point. That is not the case. Therefore, excluding material committed for long-term agreements would underestimate the baseline for deliverable supply and would result in artificially reducing spot-month position limits. We would ask the Commission to reconsider this exclusion.[12]

b) The Proposed Deadline for Submitting Deliverable Supply Estimates Is Not Operationally Feasible.

The Commission's proposal would require each DCM to submit deliverable supply estimates for physical delivery referenced contracts (listed by or executed on the DCM) by December 31 of each calendar year. Proposed Regulation 151.4(c)(2). This December 31 deadline is unrealistic, in part because much of the information needed to make these estimates has not yet been published. For example, many United States Department of Agriculture reports with the necessary data for December are not published until mid to late January, and the time lag to obtain data will be even greater for certain agricultural commodities. The proposed deadline also ignores any time required to perform the necessary calculations and prepare other information (such as the description of the methodology required in Proposed Regulation 151.4(c)(3)), as well as obtain the necessary internal reviews and approvals before these estimates can be provided to the Commission. Consequently, the January 31 deadline for the Commission to fix limits (Proposed Regulation 151.4(h)(1)) and the March 1 effective date (Proposed Regulation 151.4(h)(4)) are equally unrealistic.

[12] If the Commission decides to retain this exclusion, it should define what it understands a "long-term" agreement to be and ensure consistency with the deliverable supply definition in Appendix C of Part 38, 75 Fed. Reg. 80572, 80631 (Dec. 22, 2010). In Appendix C, the Commission states that commodity supplies that are "committed to some commercial use" should be excluded from deliverable supply, and imposes a substantial burden on DCMs by requiring that they consult with market participants to estimate these supplies on a monthly basis. The Commission should also modify the Appendix C requirement that DCMs submit monthly deliverable supply estimates "for at least the most recent *five years* for which data sources permit." *Id.* at 80632 (emphasis). Such a requirement will prove onerous for DCMs and will likely result in the inclusion of stale data. Instead, the Commission should consider requiring monthly estimates for the most recent *three* years – a time span that would still be comprehensive enough to account for variations in deliverable supply.

c) The Proposed Conditional-Spot-Month Limit Will Decrease Liquidity from the Market for Physically-Delivered Contracts and Result in Greater Price Volatility.

Under the proposed conditional-spot-month limit, a trader can hold cash-settled contract positions at levels that are five times the spot-month limit *provided* that the trader does not hold or control any positions in physically-delivered contracts based on the same commodity, even if the trader also holds 25% of the physical deliverable supply. Proposed Regulation 151.4(a)(2). As an initial matter, CME Group opposes the underlying premise – which is unsupported – that a cash-settled contract that is linked to a physically-delivered contract merits a larger spot-month limit than the physically-delivered contract on which it is based.[13] To the extent any larger limit is allowed in a cash-settled contract, we strongly oppose any restriction on participation in the referenced physically-delivered contract as a condition of acquiring that larger limit.

By definition, the physically-delivered contract and its cash-settled look-a-like are linked and arbitrage naturally occurs between the contracts. Providing for a larger limit in the cash-settled contract, and conditioning that larger limit on not participating in the physically-delivered contract, incentivizes participation in the cash-settled contract at the expense of liquidity in the referenced physically-delivered contract. It also ignores the fact that establishing or liquidating a large position in the cash-settled contract during the spot period will impact price formation in the primary contract. The Commission fails to articulate its reasoning for allowing the conditional limit or explain how draining liquidity from the physically-delivered market – the primary price-discovery benchmark for the underlying commodity – serves the public interest. In fact, undermining liquidity in the referenced physically-delivered contract simply makes it more susceptible to sudden price movements during the critical expiration period – the very harm the Commission purports to address through limits.[14]

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[13] Indeed, economic data militates against disparate treatment given that it shows that the physically-delivered contract and its linked cash-settled contract each serve a price-leading function from time to time. *See* Jeffrey H. Harris, Commodity Futures Trading Commission, Chief Economist, Testimony at Hearing to Examine Trading on Regulated Exchanges and Exempt Commercial Markets (Sept. 18, 2007), http://www.cftc.gov/ucm/groups/public/@newsroom/documents/speechandtestimony/opaharris_091807.pdf (comparing the price discovery function of the NYMEX physically-delivered Natural Gas futures contract to that of the ICE cash-settled Natural Gas contract). That physically-delivered contracts and their cash-settled look-a-like contracts should not be treated differently is further supported by the Commission's own findings. In the Commission's October 2007 "Report on the Oversight of Trading on Regulated Futures Exchanges and Exempt Commercial Markets," the Commission stated that the NYMEX physically-delivered Natural Gas futures contract was "*economically equivalent*" to the ICE cash-settled natural Gas contract (i.e. ICE Henry Financial LD1 Fixed Price contract), that the NYMEX physically-delivered and ICE cash-settled contracts "essentially comprise a *single market* for natural gas derivatives trading," and that "traders look to *both* the ICE and the NYMEX when determining where to execute a trade at the best price." The Commission also observed that the "prices on the ICE and NYMEX contracts have an *ongoing, linked relationship* that extends not only to the linked settlement price but to prices between the two contracts throughout the trading day." *See* Order Finding That the ICE Henry Financial LD1 Fixed Price Contract Traded on the IntercontinentalExchange, Inc., Performs a Significant Price Discovery Function, 74 Fed. Reg. 37988, 37989-90 (July 30, 2009) (emphasis added).

[14] This conclusion is supported by CME Group's recent experience in implementing a conditional-spot-month limit with terms comparable to those the Commission is proposing. The conditional-spot-month limit was made available in February 2010 for NYMEX cash-settled natural gas futures contracts. To analyze the effects of the conditional-spot-month limit on the physically-delivered market, NYMEX's Market Regulation Department compared the performance of the physically-delivered natural gas futures contract *before* the introduction of the conditional limit to the contract's performance *after* the introduction of the conditional limit. (Specifically, the Department compared the contract's closing range for the six contract terminations immediately preceding the introduction of the conditional limit to the closing range for the thirteen contract terminations following the introduction of the

Adding further to the incongruity of the Commission's proposal in this regard, Proposed Regulation 151.4(a)(2) prohibits an entity availing itself of a conditional limit exemption from carrying any position in the physically-delivered futures, but inexplicably allows the entity to hold up to 25% of the physical deliverable supply.[15] Clearly, if holding 25% of the physical commodity supply does not raise a market surveillance concern, there is no justification for arguing that holding an equivalent futures position in a contract that calls for delivery of the physical commodity raises such concerns.

The Commission has not articulated a basis for allowing position limits in a cash-settled contract to be five times larger than the physically-delivered contract on which it is based or explained how it can justify the anomaly of granting a conditional limit to a trader that holds 25% of the physical commodity itself, but not to a trader who holds a single physical commodity futures contract. To the extent that the Commission is concerned that a trader with a position in physically-delivered futures and linked cash-settled contracts could engage in inter-market manipulation, the Commission has comprehensive market-wide surveillance tools to address this concern. It should not, however, seek to address these concerns by undermining liquidity and performance of the benchmark physically-delivered contract at a critical time in the contract's lifecycle.

To prevent draining liquidity in the physical delivery futures market, CME Group recommends that the Commission adopt an even-handed one-to-one conditional limit for cash-settled look-a-like contracts. Traders in the cash-settled contract should have the same limit as traders in the physically-delivered contract. Neither contract should be favored with a higher ceiling or disfavored with a lower ceiling. By revising its proposal in this manner, the Commission will be promoting the public interest in price discovery and efficient risk management.

2. *Non-Spot-Month Position Limits.*

a) The Annual Recalculation of Non-Spot-Month Limits Based on Open Interest Will Lead to a Self-Reinforcing Cycle of Lower Limits and Lower Open Interest.

Pursuant to Proposed Regulation 151.4, non-spot-month position limits would be recalculated annually based on the prior year's open interest levels. More specifically, the proposed open interest formula calls

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conditional limit. The closing range refers to the price range during the final settlement determination period – the last 30 minutes of trading.)

The Department found the following: i) as a percentage of the daily price range on the last trading day, the closing range price range doubled – from 37.5% to 75%, and ii) the trading volume during the closing decreased by 13% and for the entire last trading day decreased by 8% (even as trading volume during 2010 was up by 34.5% for the physically-delivered contract overall versus 2009). In light of this empirical data, NYMEX concluded that prohibiting any participation in the physically-delivered natural gas futures contract, as a condition for maintaining five times the comparable limit in the cash-settled market, reduced participation and liquidity in determining the final settlement price of the physically-delivered contract. The resulting material adverse impact on the quality of the final settlement price for the physically-delivered natural gas futures contract has serious repercussions given that it is the single most important natural gas price in the world and relied upon as the base for pricing most commercial natural gas in North America.

[15] In this and other areas, the Commission appears to disregard the unassailable economic fact that someone who holds 25% of the physical deliverable supply could have a material impact on the price of the commodity by changing the supply and demand dynamics for the commodity. Surely such a person would have a greater impact than someone who held a permissible long or short position in the spot futures contract. The Commission never explains why such a trader should be able to maintain a position five times the federal limit.

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for setting limits for most commodities at 10% of the average all-months-combined aggregated open interest up to the first 25,000 contracts and 2.5% thereafter. The Commission asserts that – given the level of open interest in the futures markets and the likely level of open swaps based on data available to the Commission – the formula would yield large position limits that would ensure sufficient liquidity for bona fide hedgers and avoid disrupting the price discovery process.[16]

The Commission's claim does not take into account the impact of the Commission's proposed changes to its aggregation and bona fide hedging policies. Those changes may well cause traders to move to markets and instruments outside the CFTC's position limit authority.[17] Additionally, other traders likely will reduce their trading in CFTC-regulated markets to avoid the costs of onerous new reporting requirements or to mitigate potential regulatory risks associated with more complex position limit structures and the panoply of new rules regarding aggregation, exemptions, and reporting. If that decrease in trading occurs and is reflected in declining open interest, then the proposed methodology for recalculating non-spot-month limits would seem to contain a built-in bias toward lower annual limits as it calls for resetting limits annually by looking back at prior open interest levels. The self-reinforcing cycle of lower open interest levels and lower position limits would progressively impair the liquidity that supports price discovery and efficient risk management and would serve to drive market participants to shift their activities to non-CFTC-regulated markets.

CME Group opposes the automatic open interest recalculation methodology given its potential to result in progressively lower annual limits. We recommend that the Commission use the open interest formula to set limits for the first year and then evaluate the potential impact on market quality metrics and price discovery prior to making, through formal rulemaking, any subsequent adjustment that would result in a lowering of the limit in a particular contract. The formula still could be used to increase annual limits if, and when, open interest expands.

b) If Any Position Limits Are Adopted as Necessary and Appropriate and the Commission Decides To Calculate Limits Using Open Interest, Those Limits Should Be Based on a 10, 5% Open Interest Formula.

CME Group does not believe that any federal limits are necessary or appropriate. We believe federal limits will harm market performance and market participants and that a federal position accountability regime to address large aggregate positions is a far more effective, efficient, and flexible mechanism for addressing any potential market integrity concerns. But the Commission has requested comment on whether, if limits are to be adopted for energy and metals markets, they should be based on a 10, 5% of open interest formula "in order to best ensure that hedging activities or price discovery are not negatively affected." 76 Fed. Reg at 4759. As that formula would result in higher limits than the formula proposed and as we believe no limits are warranted, it follows that we would support the higher 10, 5% formula rather than 10, 2.5%, for energy and metals markets. Even with that higher formula, we are concerned that the proposed new aggregation and hedging standards could lead to unintended and adverse consequences. Our concerns would lessen if the Commission's existing aggregation and hedging standards were to be applied to a metals and energy limit regime. Unless the Commission entertains that alternative, however, we would strongly favor the higher formula as essential to preserve market liquidity and promote price discovery.

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[16] It is unclear whether the Commission has factored into this conclusion the impact of its proposed changes to its aggregation policies. As discussed *infra*, the Commission should consider those issues and advise the public of the basis for its reconsidered conclusion before it adopts final rules consistent with the APA.

[17] The Commission's failure to consider the combined impact on both market participants and market liquidity of its position limit and aggregation proposals makes it difficult to provide meaningful comment in this area, among others. *See* Part IV of these comments, *infra*.

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The Commission also requested comment on whether the current federal position limit levels should be retained for certain agricultural commodities, including, among others, Soybean, Soybean Oil, Soybean Meal, Corn, Wheat, Rice and Oats contracts traded on the Chicago Board of Trade ("CBOT"). The Commission has proposed to retain the current limits, subject to adjusting the single-month limit to the current all-months-combined limit, rather than increasing the limits consistent with the formula for other commodities. In April 2010, CBOT petitioned the Commission to increase the limits in Corn, Wheat, Soybeans and Soybean Oil based upon the open interest formula the Commission has used to establish limits in these contracts since 1992 – the same open interest formula it now proposes to apply to other agricultural, metals and energy contracts. The Commission has not acted on that petition to date and in its current proposal has offered no explanation or justification as to why the limits for certain agricultural commodities should be subject to a more restrictive standard than other commodities and remain at levels established based upon open interest levels in 2004 notwithstanding the considerable growth in these markets since that time.

CME Group believes that increases in the limits will improve liquidity in these growing markets and enhance the hedging efficiency and effectiveness of the contracts. Therefore, to the extent the Commission finds the imposition of limits necessary and appropriate, we urge the Commission to apply the same formula that it applies to other commodity contracts to CME Group's agricultural contracts.[18] Failing to adjust these limits appropriately to reflect market realities, particularly in combination with the proposed restrictive aggregation and hedging standards, will serve only to undermine liquidity, increase volatility, and impair the performance of contracts which serve as critical hedging vehicles and important benchmarks for global commodity pricing.

c) Class Limits Do Not Reflect Economic Reality, Are Not Designed to Address Excessive Speculation and Market Concentration Concerns, and Will Impose Unnecessary Costs.

In promulgating regulations, the Commission must ensure that those regulations reflect economic reality and do not elevate form over substance. *Cf. SEC v. W.J. Howey Co.*, 328 U.S. 293, 299 (1946) (noting that, in determining the nature of a particular transaction, "the form of the transaction is of little consequence" and substance governs); *CFTC v. Co-Petro Mktg. Grp., Inc.*, 680 F.2d 573 (9th Cir. 1982) (stating that, to determine whether a particular contract is a futures contract, "[t]he transaction must be viewed as a whole with a critical eye toward its underlying purpose"). Both the statute and the Commission's proposal recognize explicitly that the only swaps that will be subject to the position limit regime are swaps that are found to be "economically equivalent" to futures and options contracts. *See, e.g.*, New CEA § 4a(a)(5) (requiring the Commission to develop limits on referenced futures contracts *concurrently* with limits on *economically equivalent* swaps, ensuring that the limits have similar requirements, and to establish such limits on both types of instruments *simultaneously*).

The Commission's proposed aggregate limits reflect the economic reality that the futures and swaps subject to the proposed limits are "economically equivalent." Those aggregate limits would apply to all referenced contracts (futures, options, and economically equivalent swaps) based on the same underlying commodity and would allow for the netting of futures and options against economically equivalent swaps. This netting across contract classes would capture a trader's actual speculative position holdings, thereby ensuring that aggregate limits apply to prevent what the Commission deems to be "excessive speculation" and not any lower levels of speculation. Aggregate limits for futures, options, and economically equivalent swaps in the same commodity could also be argued to address (at least in part) "concentrated market power" in a commodity – an objective the Commission seems to be attempting to achieve with its proposal.[19] In addition, federal aggregate limits would allow DCMs and SEFs to

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[18] If the Commission decides not to apply the same formula to agricultural markets, it should at a minimum adopt the position limit levels that CBOT petitioned for in April 2010.

[19] *See* 76 Fed. Reg. at 4777 (noting that the Commission has interpreted its obligation to promote market integrity "to include ensuring markets do not become too concentrated") (Statement of Chairman Gary Gensler).

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monitor appropriately their individual markets to prevent any market participant from exercising undue market power within a particular submarket. Thus, federal aggregate limits coupled with diligent self-regulatory submarket surveillance should provide strong safeguards against price manipulation or other distortions of market prices.

In contrast, the proposed federal class limits distort economic reality and should not be adopted. Those limits apply *separately* to DCM futures/options, as one contract class, and economically equivalent swaps, as another, and do not allow for netting across contract classes. As a result, the class limits do not apply to a trader's actual net speculative position holdings. The following hypothetical illustrates the flaw in this aspect of the Commission's proposal: The class limit for futures contracts and the class limit for economically equivalent swaps are each set at 1000 contracts. (The aggregate limit is also 1000 contracts.) Trader has 1020 long futures and 1040 economically equivalent short swaps in the same commodity. Trader would be found to exceed simultaneously *both* the futures class limit for its long position and the economically equivalent swap limit for its short position even though, as a matter of economic reality, Trader has a net position of only 20 short contracts. This example clearly illustrates that the Commission's proposed class limits are not designed to prevent speculation that could be considered to be *excessive* by any measure as those limits would prohibit even *de minimis* amounts of speculation.

The class-limits approach is further flawed as it is conceivable, for example, that there could be physically-settled and cash-settled futures contracts on a particular commodity as well as a cash-settled swap on the same commodity. The Commission offers no explanation as to why the positions in the two futures contracts are eligible to be netted, but the swap and futures contracts cannot be netted. Again, the class limit proposal simply appears to create artificial inefficiencies in the market rather than serving a legitimate economic or regulatory purpose.

The Commission claims its proposed class limits "ensure that market power is not concentrated in any one submarket." 76 Fed. Reg. at 4759. The Commission's "market power" concerns, of course, cannot be attributed solely to speculative positions, and therefore are a misplaced basis for this aspect of the proposal. In any event, as the above example shows, the Commission's proposal is divorced from economic reality. The proposal envisions that the same trader would be engaged in a game of self-tug-of-war pulling simultaneously in the direction of having too much market power on the long side and too much market power on the short side in economically equivalent instruments. Yet the real, net position of the trader is net short only 20 contracts. Also, as demonstrated above, there may be multiple submarkets within a particular class, and it is unnecessary for the Commission to establish federal class limits when DCMs and SEFs have the ability, as well as the obligation under core principles, to curb undue concentrations as they arise on individual markets and to prevent the potential for price manipulation, price distortions, congestion, and disruptions of the delivery or cash-settlement process.

Class limits, moreover, would have unintended negative consequences. Such limits will create inefficiencies as traders move positions from one class to another to avoid limits in a particular class even when not motivated to do so by market forces. The imposition of class limits – as a supposed complement to aggregate limits – would also create an unnecessary administrative burden of monitoring and enforcing multiple position limit levels.

CME Group has no objection to federal aggregate limits that are "necessary" and appropriately set on a per commodity basis because those limits recognize that the futures and swaps positions subject to the limits are "economically equivalent" and properly target a trader's actual and total speculative position holdings. However, we oppose the proposed class limits on the grounds that they distort economic reality, are not linked to the statutory purpose in section 4a(a)(1), are based on concerns better addressed by DCM and SEF market surveillance powers, and will likely have negative consequences.

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3. *Aggregation Policy.*

Among other changes to the Part 150 aggregation framework, the Commission's proposed aggregation policy eliminates the longstanding "independent account controller" aggregation exemption and includes a new "identical trading strategy" aggregation rule. The effect of these proposed changes would be to require aggregation of positions in accounts that are merely related by a passive common ownership. There is no basis for treating such accounts as though they were the *same* speculative entity where their speculative trading decisions are controlled by *different*, independent managers. Moreover, such unnecessary aggregation will make the Commission's purportedly high limits illusory and compromise the legislative goals of ensuring sufficient liquidity for bona fide hedgers and protecting the price discovery function of the underlying market.

a) Eliminating the Independent Account Controller Aggregation Exemption Inexplicably Departs from the Commission's Longstanding and Effective Part 150 Aggregation Framework and Will Have Severe Negative Consequences.

The Commission's Part 150 aggregation policy, like the proposed aggregation framework, requires a trader to aggregate positions in accounts in which the trader controls trading or has a 10% or greater ownership or equity interest. However, Part 150 also allows for disaggregation of positions based on the independence of trading control. In particular, Regulation 150.3(a)(4) permits "eligible entities" (e.g. mutual funds, commodity pool operators, commodity trading advisors, insurance companies, banks, etc.) to disaggregate positions that are carried for them in the separate accounts of independent account controllers. If the independent account controller is affiliated with the eligible entity or another independent account controller, each of the affiliated entities must satisfy rigorous independence standards. The Commission developed this regulation – known as the "independent account controller" aggregation exemption – in response to the growth of professionally managed trading accounts, and, for decades, both the Commission and U.S. futures exchanges have granted this disaggregation relief.

The longstanding policy of disaggregating positions in separately controlled, though commonly owned, accounts is sensible and sound. Entities that are under common ownership cannot be viewed as trading in concert or trying to affect prices in the same way if they are subject to independent management, often with separate information systems and procedures for back office operations. Simply stated, such entities should not have their positions aggregated because they are not acting as a single speculative trader. Furthermore, the Commission has observed that the independent account controller aggregation exemption "has generally worked well," "provid[ing] flexibility to the markets [and] accommodating the continuing trend toward professional management of speculative trading accounts." Revision of Federal Speculative Position Limits and Associated Rules,64 Fed. Reg. 24038, 24043 (May 5, 1999).

The Commission now proposes to eliminate this longstanding exemption that it has explicitly recognized as being effective. According to well-established Supreme Court precedent, when "an agency change[s] its course by rescinding a rule[, it] is obligated to supply a *reasoned analysis* beyond that which may be required when an agency does not act in the first instance." *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 41-42 (1983) (emphasis added); *see also W. States Petroleum Ass'n v. EPA*, 87 F.3d 280, 284 (9th Cir. 1996) (stating that an agency "must clearly set forth the ground for its departure from prior norms"). An agency is subject to this higher burden precisely because "there is . . . a presumption that [the] policies [committed to it by Congress] will be carried out best if the settled rule is adhered to." *See State Farm*, 463 U.S. at 41-42.

In *State Farm*, the National Highway Traffic Safety Administration ("NHTSA") rescinded a requirement that new motor vehicles be equipped with passive restraints (automatic seatbelts or airbags) to protect the safety of vehicle occupants in the event of a collision. NHTSA explained that its rescission was based on its substantial uncertainty that the passive restraint requirement would produce significant safety benefits. The Supreme Court found that the agency could not justify its rescission "merely [by] recit[ing]

the terms 'substantial uncertainty,'" but instead "must explain the evidence which is available, and must offer a rational connection between the facts found and the choice made." *See id.* at 51-52 (internal quotations and citations omitted). Because NHTSA's explanation was not sufficient for the Court to conclude that the rescission was "the product of reasoned decisionmaking," the Court ultimately held that the agency's rescission was arbitrary and capricious. *See id.* at 52.

Similar to NHTSA's "substantial uncertainty" justification for its rescission, the Commission's explanation for its removal of the independent account controller exemption rests on the notion that the exemption "*may* not be appropriate." More specifically, the Commission states that "allowing traders to establish a series of positions each near a proposed position limit, without aggregation, *may not be appropriate*" "[g]iven that the proposed framework sets high position levels that are reflective of the largest positions held by market participants, permits for the netting of positions for like referenced contracts within each applicable position limit, and includes a conditional-spot-month limit for cash-settled contracts and exemptions for bona fide hedging." 76 Fed. Reg. at 4762 (emphasis added).

The Commission not only fails to offer any supporting evidence for the possible "inappropriateness" of the independent account controller exemption, but its proffered rationale is also untenable. Just because the features of the proposed position limit levels – as described by the Commission – would not allegedly affect many traders under the existing position limit aggregation standards does not mean that repealing those aggregation standards is warranted. The Commission has offered no analysis of the only relevant question: how will repeal of its current aggregation rules combined with the imposition of new and expanded limits affect markets and market participants. In fact, the Commission is completely silent on this issue. Like NHTSA, the Commission has failed to satisfy the "reasoned analysis" burden for its change in longstanding policy and, accordingly, its repeal of the independent account controller aggregation exemption would violate the APA.[20]

The Commission does not offer a substitute for the "independent account controller" aggregation exemption. Rather, the Commission proposes a new exemption – the "owned non-financial entity" exemption – which it admits will only address "some of the concerns" flowing from the elimination of the independent account controller exemption. *See id.* This proposed exemption would allow an entity with a 10% or greater ownership or equity interest in a non-financial entity to disaggregate its positions from those of the owned non-financial entity where the owned non-financial entity is independently controlled and managed. Proposed Regulation 151.7(f). The Commission offers no rationale for limiting this exemption to non-financial entities. Indeed, its statement that aggregating positions would be inappropriate where "operating companies may have complete trading and management independence and operate at such a distance from the holding company" is just as true for financial operating companies as it is for non-financial operating companies. *See* 76 Fed. Reg. at 4762. Where agencies do not articulate a basis for treating similarly situated entities differently, as the Commission fails to do here, courts will strike down their actions as arbitrary and capricious. *See, e.g.*, *Indep. Petroleum Ass'n of America v. Babbitt*, 92 F.3d 1248 (D.C. Cir. 1996) ("An agency must treat similar cases in a similar manner unless it can provide a legitimate reason for failing to do so.") (*citing Nat'l Ass'n of Broadcasters v. FCC*, 740 F.2d 1190, 1201 (D.C. Cir. 1984)).

Ultimately, the Commission's proposed policy of forcing aggregation in certain situations where independent trading control exists would be unwise, inappropriate, and unworkable. Entities that are commonly owned but under separate control – such as independently managed financial operating

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[20] Based on its Federal Register notice, the Commission also appears to be unaware that market participants and even DCMs rely on the independent account controller exemption in areas beyond federal position limits, including trading in interest-rate futures and other non-agricultural products. *See, e.g.*, CME Rule 559.E. ["Limited Exceptions to Aggregation for Independently Controlled Positions"] (referring to the Part 150 independent account controller aggregation exemption and providing for such an exemption for Treasury futures positions). Thus, repeal of the independent account controller exemption will surely have unintended consequences which the Commission should consider and on which it should request public comment.

companies which are not covered by the "owned non-financial entity" exemption – would need to share position and trading information on a real-time basis in order to monitor and allocate limited position volumes. Sharing position information among market competitors is not generally favored because it could be said to encourage competitors to act in concert impermissibly. It is unusual that Commission rules would encourage such behavior. Sharing of information also would have the perverse effect of raising the potential for trading by pre-arrangement or other trade practice abuses that might occur as the result of collusion between otherwise independent traders. Further, the disclosure of information may breach the confidentiality of a particular entity's trading strategies or compromise an entity's fiduciary duties to its clients.

Moreover, entities would have to implement massive, costly infrastructure changes – e.g. dismantling information barriers and restructuring information systems and procedures – to share information and manage positions on a real-time basis even though, again, these entities are not acting as a single speculative entity. Faced with the many compliance costs flowing from limited disaggregation relief for separate control, market participants are likely to move their trading activity to unregulated, less transparent markets, thereby reducing the liquidity and disrupting the price discovery of U.S. commodity markets. Certainly, this is not what the Commission and Congress seek to achieve.

Because the independent account controller aggregation exemption provides market participants with meaningful relief and has not been shown to cause any abuses or problems in commodity markets, CME Group recommends that the Commission retain this longstanding exemption in any new position limit regime.

b) The Proposed Identical Trading Strategy Aggregation Rule Does Not Relate to Limiting Price Volatility and Will Unnecessarily Restrict Index Fund Trading Activity.

Proposed Regulation 151.7(d) would require a trader with *any* ownership or equity interest in multiple accounts or pools to aggregate positions in those accounts or pools as long as the accounts or pools have "identical trading strategies." In effect, the "identical trading strategy" aggregation rule serves as pair of suspenders to the belt of the 10% or greater ownership aggregation standard. Though the Commission does not define "identical trading strategy," it states the rule would apply where "a trader seek[s] a large long-only position in a given commodity through specific positions in multiple pools" and notes that such pools would include "passively managed index funds." *See* 76 Fed. Reg. at 4762.[21] Based on the text of the proposed rule and the Commission's guidance, the rule can be read to sweep broadly, requiring every passive investor in a long-only index fund to aggregate the positions of that fund with the positions of all other long-only index funds in which it invests. Because such passive investors do not have any control over the trading of the index funds in which they have invested, forcing them to aggregate the positions of the index funds will not prevent speculative trading resulting in "unreasonable" or "unwarranted" price fluctuations. Rather, the required aggregation will have negative consequences for index funds, which even the Commission staff has found did not cause commodity price fluctuations, and the market at large. *See* CFTC Staff Report on Commodity Swap Dealers & Index Traders at 27-30 (Sept. 2008) (finding no causal relationship between commodity index fund activity and sudden price movements in certain agricultural commodities). In particular, commodity index investors will be more restricted in their ability to invest in commodities as a means for portfolio diversification and, in many cases, to specifically hedge against rising inflation. *See id.* at 9. The potential decrease in index fund

[21] The lack of a definition for "identical trading strategy" remains a fundamental flaw in the proposed aggregation rule. Not all long or short commodity index funds are alike. Many index funds have different approaches to the process of rolling positions, the trading months when positions are established, and the underlying indexes. As stated in the preamble to the proposal, the Commission suggests that despite these differences the funds are "identical." The Commission should reconsider its proposal on this basis alone.

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activity will also reduce valuable market liquidity on which commercial participants depend for hedging purposes, especially in the deferred months, and which promotes effective commodity price discovery.

CME Group urges the Commission not to adopt the proposed identical trading strategy aggregation rule. In essence, the proposal would punish common investors in long-only (or short-only) funds and treat them as if they controlled trading for the funds in which they are mere investors. No “manipulators” or “excessive speculators” would be dissuaded or identified through this policy. But the proposal could chill investment interest in index funds. The resulting decline in market liquidity would be serious, especially in deferred months where hedgers need it, and would undermine, rather than serve, the statutory goals identified in new CEA Section 4a(a)(3). Accordingly, the Commission should abandon this ill-conceived experiment in aggregation policy.

If the Commission persists, however, it should write the proposal to make clear that an investor with less than a 10% interest in more than one fund or account with an identical trading strategy should only be considered for position limit purposes to hold a position equal to its proportionate share of the funds or accounts at issue. We recognize that this approach may be administratively challenging for funds to administer, comply with, and enforce because investors will not always know what percentage of a fund they own. Those challenges only underscore the inappropriateness of the identical trading strategy basis for aggregation.

4. *Exemptions.*

As discussed in the subsections below, the Commission’s proposed exemptions from position limits are too limited and should be interpreted more broadly so as not to curb legitimate hedging activity and otherwise create market disruptions.

a) The *Bona Fide* Hedging Definition Is Unduly Narrow and Will Result in Negative Policy Consequences.

The “bona fide hedging” definition in CEA Section 4a(c)(2), which is restated in Proposed Regulation 151.5(a), in part *requires* that a “bona fide hedging” transaction or position represent a substitute for a transaction or position in the physical marketing channel. This narrow definition of “bona fide hedging” for purposes of position limits is at odds with the understanding of “hedging” for purposes of the commercial end user exemption from the clearing and exchange-trading mandates and for purposes of the major swap participant (“MSP”) definition. For example, unlike the bona fide hedging definition in section 4a(c)(2), the hedging standard under the MSP definition includes swap positions “maintained by [pension plans] for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan.” New CEA 1a(33). With respect to the commercial end user exemption, the Commission’s proposed definition for hedging “covers swaps used to hedge or mitigate *any* of a person’s business risks,” as defined by six broad categories in the proposal. *See* End-User Exception to Mandatory Clearing of Swaps, 75 Fed. Reg. 80747, 80752 (Dec. 23, 2010) (referring to Proposed Rule § 39.6(c)(1)(i)) (emphasis added).

CME Group encourages the Commission to use its exemptive authority under new CEA Section 4a(a)(7) to grant exemptions to market participants who use futures, options, or swaps when economically appropriate to the reduction of risks they face in their enterprises. Such an approach would be consistent with the “hedging” standards elsewhere in the CEA and is well within the scope of section 4a(a)(7), which gives the Commission unprecedented authority to exempt from any position limit rule, with or without conditions, “any person or class of persons, any swap or class of swaps, any contract of sale for future delivery or class of such contracts, any option or class of options, or any transaction or class of transactions.” For example, the Commission solicits comment on whether an exemption should be granted to an agent that is not responsible for the merchandising of cash commodity positions, but is linked to the production of the physical commodity – for instance, an agent who provides crop insurance. Clearly, this is an example of an appropriate hedge and illustrates as well that the Commission’s definition

is short-sighted and will negatively impact legitimate and prudent risk management.[22] An application for a hedging exemption should be judged on its merits in terms of the specific risks to be hedged, the relevant price relationships, the proposed position sizes, and the operational procedures for establishing and lifting the hedge.

If the Commission does not extend its section 4a(a)(7) exemptive authority to non-speculative trading activity that falls outside the narrow scope of the bona fide hedge definition, negative policy consequences will result. Market participants would be forced to either speculate on those price risks (i.e. not establish any positions to mitigate the risk), and potentially increase costs to consumers, or hedge their risks through transactions that lie outside the CFTC's position limit authority. Either strategy would undermine the Commission's mission to promote liquidity and protect the price discovery function of its regulated markets. The Commission should thus broadly interpret its exemptive powers and grant exemptions to market participants who are not seeking to establish positions in the futures markets for speculative purposes but rather to serve their legitimate commercial and financial hedging needs.

b) The Exemption for Pre-Existing Positions Could Have Unintended Harmful Consequences.

An exemption from position limits also would be available for pre-existing futures and options positions – i.e. positions established in good faith prior to the effective date of the limits. The pre-existing position exemption attempts to address the difficulty in applying new position limits to contracts with existing material open interest. The better way to avoid these problems is to phase in the limits such that they begin to apply with deferred contract months that have no material open interest rather than changing the rules of the game on market participants during the game. If the Commission does not adopt that approach, it should be careful that the total package of any new position limit regime will not disrupt the price discovery process by forcing reductions in market positions to meet federal limits.

As proposed, the pre-existing position exemption will have particularly adverse effects on swap dealers and index funds. The Commission proposes to permit swap dealers to continue to manage the risk of a swap portfolio that exists at the time of implementation of the proposed regulations consistent with a prior exemption, but no new swaps will be covered by prior exemptions. Although CME Group strongly believes that all swap dealers should be eligible for exemptions to hedge risks associated with their OTC marketmaking regardless of whether the counterparty is a bona fide hedger, it is unclear why the Commission's proposed rules do not offer this same relief to swap dealers with swap portfolios in contracts that were not previously subject to limits and therefore did not require exemptions. These parties should also be eligible to continue to manage the risk of their swap portfolios in the same manner.

Similarly, index funds have established pre-existing positions in good faith to provide thousands of investors with a cost-effective opportunity to diversify their portfolios and hedge inflation risk. These entities should be afforded the same relief described above. If index fund managers do not get an exemption to continue managing the current assets in these funds, they would be forced to liquidate the

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[22] Similarly, the Commission's prohibition on cross-commodity hedging in the last fives days of trading (see Proposed Regulation 151.5(c)(v)) is illogical and contrary to sound hedging practices. Many market participants hedge one commodity with another commodity, or with a basket of other commodities, to reduce the risks they face in their commercial enterprises. For example, an airline might seek to hedge against a price rise in jet fuel by establishing futures positions in crude oil and/or heating oil, which are highly correlated markets. The airline would then liquidate the positions in an orderly manner (sometimes even ratably) over the pendency of the spot month through expiry. Ultimately, the airline benefits the market by hedging its price risk in an economically appropriate manner and contributing to liquidity and price discovery. CME Group is aware of no reason, and the Commission offers no basis, for restricting this legitimate hedging activity in the last five days of trading. The proposed restriction on cross-commodity hedging thus seems to be yet another instance of the Commission inadvertently draining liquidity in the last days of a contract.

portion of their position that exceeds the new limits. This liquidation could be disruptive to the market. Index fund managers who do not or cannot roll-over positions would also be deviating from disclosed-to-investors trading strategies. To avoid potential disruptions to index funds' businesses as well as the market in general, the Commission should treat roll-over positions as re-established positions that fall within the pre-existing positions exemption as opposed to wholly new positions.[23]

III. THE COMMISSION MUST ADDRESS THE ETF LOOPHOLE IN ITS PROPOSAL.

The Commission's proposal does not apply to physical commodity holdings by exchange-traded funds in commodities (metals, energy and potentially others). These funds use investment proceeds to buy and hold physical commodities. Investors in these funds are attempting to obtain long market exposure for the particular commodity at issue in order to hedge against inflation, to diversify their portfolio holdings, or to take a market view. Unlike market participants that establish futures or other commodity derivatives, including index funds that only use derivatives, exchange-traded funds that use investment proceeds to purchase and hold physical commodities theoretically could be inadvertently affecting the supply and demand dynamics for a commodity. We know the Commission does not regulate these funds. However, we believe that any Commission position limits proposal that does not apply to these funds contains a serious loophole. We would urge the Commission to reassess its position.

The Commission may believe it does not have jurisdiction to include positions in exchange-traded funds within its proposal. If that is the case, we would urge the Commission to coordinate its policy in this regard with the Securities and Exchange Commission. Otherwise, Commission-set position limits will simply invite market participants that are looking for unlimited commodity exposure to participate in exchange-traded funds and thereby avoid the federal limits the Commission would impose. That major loophole in the Commission's position limit regime – which encourages potentially higher commodity prices – does not appear to be consistent with what Congress intended.

IV. THE POSITION LIMITS PROPOSAL DOES NOT ALLOW FOR MEANINGFUL AND INFORMED PUBLIC COMMENT AS THE APA REQUIRES.

The APA requires that a notice of a proposed rule include "sufficient detail on its content and basis in law and evidence to allow for meaningful and informed comment." *See Am. Med. Ass'n v. Reno*, 57 F.3d 1129, 1132 (D.C. Cir. 1995). In contravention of the APA, the Commission's notice fails to discuss the reasons for and the implications of the Commission's proposed position limit rules. This failure has resulted in a proposal that is essentially a fiat, rather than an invitation to engage in an informed dialogue as the APA contemplates. We recommend that the Commission revise the Release and re-publish the revised notice of proposed rulemaking to allow for meaningful comment before it considers whether to adopt any final rules. The following list identifies the key issues that the Commission's notice of proposed rulemaking must address to comply with the APA:

Issues Presented by the Commission's Proposal that Must Be Addressed in Order To Give the Public a Meaningful Opportunity To Comment:

- the necessity of the proposed position limits
- the appropriateness of the proposed position limit regime

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[23] To avoid the possibility that index funds would artificially increase their activity prior to the effective date of any adopted limits, the Commission could make the exemption applicable to only those positions existing at the time of the *adoption* of position limit rules.

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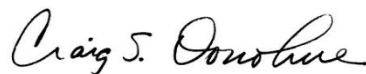
- the basis for the Commission's "reasonable judgment" that position limits should be implemented
- the enforceability of spot-month limits in the absence of adequate swap market data
- the implications of the condition for qualifying for a conditional-spot-month limit on liquidity and price volatility in the physically delivered market
- the implications of establishing position limits on the levels of open interest in the market
- the reason(s) for treating agricultural commodities differently than other commodities in establishing position limits
- the reason(s) for rescinding the independent account controller aggregation exemption
- the reason(s) for limiting the "owned non-financial entity" aggregation exemption to non-financial entities
- the implications of the "identical trading strategy" aggregation rule on market participants and the market in general
- the impact of the proposed aggregation policy on the setting of the levels for position limits
- the interaction of the effect of imposing position limits and the purposes of Dodd-Frank
- the incentives created by the proposal for participating in exchange-traded funds that buy and hold physical commodities, among other entities and instruments that lie outside the Commission's position limit authority
- any analysis of how the proposal attempts to ensure that position limits will not cause price discovery in the commodity to shift to trading on foreign boards of trade

Conclusion

CME Group appreciates the opportunity to offer the foregoing comments on the Commission's Notice of Proposed Rulemaking regarding position limits for physical commodity derivatives. We hope the views expressed herein prove helpful to the Commission and we are available to answer any questions the Commission may have.

Sincerely,



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APPENDIX

CME Group submits the following technical comments on the Commission's Notice of Proposed Rulemaking Re: Position Limits for Derivatives:

I. Spot Month for Class III Milk

In Proposed Regulation 151.3(a)(5)(ii), the Commission establishes a spot-month definition for the cash-settled Class III Milk futures, which it proposes as the period beginning at the close of business on the eleventh day prior to the last trading day. Under current contract terms, the spot month is not defined and there is no unique spot-month position limit; instead, the single-month limit applies throughout the expiration month. The Commission has not explained how it arrived at the spot month definition for Class III Milk or why it will be effective in deterring manipulation, particularly in light of how USDA determines the Class III price that is used for final settlement purposes. The final settlement date for Class III Milk occurs early in the calendar month following the expiring month, but varies based on the USDA announcement date. To the extent that a unique spot month definition is required, it should be as of the close of business immediately preceding the first business day of the contract month, which has the same effect as current practice (where the spot month limit equals the single month limit), and which is also consistent with the definition of the spot month for Class IV Milk.

II. Spot Month for Feeder Cattle

The Commission also proposes to change the definition of the spot month for Feeder Cattle. The existing CME rule language defines the spot month as the last ten days of trading and the Commission proposes to change the definition to "at the close of business on the eleventh day prior to the last day of trading." *See* CME Rule 10202.E. Again, the Commission does not explain its justification for changing the current terms and CME Group is not aware of any reason that the spot-month definition should be altered.

III. Spot Month for Grain Contracts

The definition of spot month for the grain contracts in Proposed Regulation 151.3(a)(2) is inconsistent with the current definition and practice. That proposed regulation defines the spot month as commencing "[a]t the close of business three business days prior to the first trading day in the delivery month." The current definition of spot month in Regulation 150.1, which covers the grain contracts, states that the spot month "begins at the close of trading on the trading day preceding the first day on which delivery notices can be issued to the clearing organization of a contract market." In accordance with the current definition, the practice of the CBOT grain markets is that the spot month begins at the close of trading *two* business days prior to the first day of trading in the delivery month.

IV. Initial Spot-Month Position Limit for Live Cattle

The Commission proposes to establish initial spot-month position limits at the levels currently imposed by DCMs. For live cattle, the current exchange limit for the spot month (as defined in Proposed Regulation 151.3(a)(4)) is 300 contracts. *See* CME Rule 10102.E.c. The Commission incorrectly identifies the current exchange limit for live cattle as 450 contracts in the Appendix to proposed Part 151. If the Commission intends to adopt the current exchange limits as Commission-limits in the first implementation phase, then it should use the correct exchange limits.

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