Alternative Investment Management Association

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

17 January 2012

Dear Sirs,

Position Limits for Futures and Swaps – interim final rule

The Alternative Investment Management Association (AIMA)[1] welcomes the opportunity to provide comments on the Commodity Futures Trading Commission's (the Commission) interim final rule on position limits for futures and swaps, which establishes spot-month limits for 28 physical commodity futures and options contracts and their economically equivalent swaps. We also wish to highlight our concerns regarding the deliverable supply estimates that the Commission will use to calculate all spot-month position limits.

AIMA's comments

Interim Final Rule

The goal of the position limits rule, set out at section 6A(a) of the Commodity Exchange Act of 1936 (as amended) (the Act), is to ensure that, with respect to holding positions in commodity futures or economically equivalent swaps contracts that perform or affect a significant price discovery function, traders in those contracts do not cause "sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity". In essence, section 6A(a) and the Commission's Final Rule, published in the Federal Register on 18 November 2011, seek in particular to avoid unnecessary 'congestion' of interest around settlement of a contract in the delivery month (the Spot-Month), which causes its price to increase significantly before settlement.

Respondents to the notice of proposed rulemaking (NPR), published on 26 January 2011, commented that the Commission may wish to adopt Spot-Month position limits that have either:

- a larger ratio for cash-settled contracts cf physically-settled contracts; or
- no limit on cash-settled contracts at all.

AIMA commented in response to the NPR that positions taken in physically-settled contracts are likely to have some form of direct impact on the market price of the underlying commodity in the Spot-Month. However, cash-settled derivatives contracts may have a less direct effect and, thus, we felt that it may be beneficial either to have a limit multiple times that for the physically-settled contract or for the Commission to consider whether the limits for cash-settled contracts were appropriate at all.

As AIMA and other industry participants have stated, the relationship between the cash-settled commodity derivatives market and the underlying cash commodity market (the Cash-Market) is not fully understood. Contracts under which market participants are never required to take physical delivery of an underlying commodity cannot correspondingly reduce the amount of supply of the physical commodity available in the Cash-Market. The lack of impact on the physical supply may mean that a position taken in a cash-settled contract

[1] AIMA is the trade body for the hedge fund industry globally; our membership represents all constituencies within the sector – including hedge fund managers, fund of hedge funds managers, prime brokers, fund administrators, accountants and lawyers. Our membership comprises over 1,300 corporate bodies in 45 countries.

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would not be expected, in any meaningful or significant way, to increase or decrease the Cash-Market price of the underlying commodity (i.e., the position is unlikely to have a 'significant price discovery function'). However, cash-settled contracts provide a way for parties who are exposed to the Cash-Market (e.g., manufacturers) to hedge their exposures against adverse price movements. Professional investors also use investments in cash-settled commodity derivative contracts as an uncorrelated investment to maintain a diversified portfolio, ultimately helping to reduce the risks to investors' capital.

Given the benefits of being able to invest freely in cash-settled contracts, we believe that the Commission should give serious consideration as to whether there are reasons for having limits for Spot-Month cash-settled commodity derivative contracts and, if so, what those limits should be. Section 6A(a)(4) of the Act lists considerations to be taken into account when determining whether a swap contract performs a 'significant price discovery function'. These include: (i) the price linkage between the swap and Cash-Markets; (ii) the ability to arbitrage between the two markets; (iii) the extent to which the Cash-Market prices are based on the swap-market prices; (iv) the impact of liquidity in the Cash-Market as a result of trading in the swap-market; and (v) other material factors. We believe that it is possible that physical-delivery contracts have a different relationship to the price discovery function in relation to Cash-Markets from that of cash-settled contracts.

We would, therefore, support the Commission conducting an independent study and cost-benefit analysis in this regard, as we do not believe the evidence on which this rule is based is sufficient. If the outcome of this is to demonstrate a clear causal link between cash-settled contract positions and underlying Cash-Market prices, then we would urge consideration of what limits may be appropriate.

If the Commission concludes that limits for cash-settled contracts are appropriate, then we believe that the limits should be set as a multiple of the physically settled limits, according to clear evidence that suggest the correct multiplier. We believe that there is no specific evidence to suggest that a multiple of five times the physical-settled contract position limit is the appropriate ratio and we believe that a final ratio cannot be agreed until a study on the actual impact on Cash-Markets has been conducted. Given the goals set out in section 737 of the Dodd-Frank Act, the agreed ratio should be appropriate to:

- diminish, eliminate, or prevent excessive speculation;
- deter and prevent market manipulation, squeezes, and corners;
- ensure sufficient market liquidity for bona fide hedgers; and
- ensure that the price discovery function of the underlying market is not disrupted.

Following the conclusion of the study discussed above, we believe that each specific type of commodity merits a different sized position limit based on the evidence, rather than applying a one-size-fits-all approach (e.g., just having a five times multiplier). The Commission should also monitor over time these ratios to ensure that the multiplier used remains appropriate.

We believe that the proposed rules around holding both cash- and physically-settled contracts for the Henry Hub Natural Gas contract, which have different limits based on a five times ratio, are appropriate and should be applied for all 28 core referenced futures contracts.

Estimated deliverable supply

In the Commission's final rule on position limits for futures and swaps, the spot-month position limits will be those set out at Annex A of the rule, being applicable from the date that the limits comes into force up to the date at which they are revised[2]. At the date the limits are revised, the position limits will be based on the estimates of deliverable supply agreed between the Commission and the relevant designated contract markets (DCMs). The spot-month limit will be 25% of the estimated deliverable supply, which will be reconsidered annually or biennially (depending on the type of contract) thereafter based on the latest estimated deliverable supply figures.

2 i.e., 1 January in the second calendar year following the date at which the rule defining the definition of "swap" is published

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The limits in Appendix A are based on the limits previously used by the DCMs, which themselves are based on estimates of deliverable supply. However, we are aware that some of the estimated delivery supply numbers on which the position limits in Appendix A are based are out of date and do not reflect current market supply of the commodities. For example, the supply figure on which the natural gas contract position limits would be based has not been updated for around 12 years. We understand that it is likely that the deliverable supply estimates for many of the contracts will have increased meaningfully since they were last calculated.

We believe that the Commission should seek new estimated deliverable supply numbers from the DCMs today and ensure that, when the regime is introduced, from the start limits are based on up-to-date evidence based numbers. It should not wait two years to obtain these and should further consider whether annual and biennial updates are appropriate or whether updates to the estimates should be considered more frequently. Without using accurate and appropriate supply numbers, the Commission cannot hope to introduce an appropriate position limits regime that achieves its goals of protecting against excessive speculation and manipulation while ensuring that the markets retain sufficient liquidity for bona fide hedgers and that their price discovery functions are not disrupted.

As a prerequisite to any study or adjustment of the position limit ratios between physically-settled and cash-settled contracts, the Commission must ensure that the estimated deliverable supply numbers the limits are based on are appropriate.

Conclusion

We believe that the Commission has not thus far provided sufficient evidence and cost-benefit analysis to show that cash-settled contracts have a significant impact on underlying Cash-Market commodity prices. Therefore, we encourage the Commission to study the relationship between the Cash-Markets and the cash- and physically-settled futures and swaps markets, looking at both the costs and the benefits of this rule and only then introduce rules for cash-settled Spot-Month commodity derivatives if they are appropriate and at the correct ratio above that for physically-settled contracts.

The Commission must also ensure that position limits are based on suitable estimated deliverable supply numbers. This can only be done if the Commission begins the regime with the correct numbers and updates the estimates as frequently as is necessary to ensure the limits are appropriate to achieving the goals of the final rule.

We thank you for this opportunity to comment on the Commission's interim final rule and are, of course, very happy to discuss with you in greater detail any of our comments.

Yours faithfully,

Jiří Król
Director of Government and Regulatory Affairs

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