January 17, 2012

VIA ELECTRONIC SUBMISSION

David A. Stawick
Secretary
Commodity Futures Trading Commission
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Comments on Interim Final Rule Regarding Position Limits for Futures and Swaps (RIN 3038-AD17)

Dear Mr. Stawick:

The Edison Electric Institute ("**EEI**") respectfully submits these comments in response to the Commodity Futures Trading Commission's (the "**Commission**") request for additional comments on aspects of its rulemaking regarding Position Limits for Futures and Swaps[1] (the "**Position Limits Rule**"), adopted on October 18, 2011 pursuant to Section 737 of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**").[2]

Specifically, EEI is responding to the Commission's request for additional comment on Section 151.4(a)(2) of the Position Limits Rule (the "**Interim-Final Rule**"), which imposes spot-month position limits on certain cash-settled futures and swap contracts and was adopted on an Interim-Final basis. The Commission sought additional comment from market participants regarding, *inter alia*, whether the Interim-Final Rule best maximizes the four objectives enumerated in CEA Section 4a(a)(3)(B) with respect to position limits established by the Commission.[3]

Due to the absence of any data indicating that cash-settled contracts are susceptible to "excessive speculation" or manipulation, EEI does not believe the Interim-Final Rule maximizes the objectives in CEA Section 4a(a)(3)(B) and, therefore, EEI respectfully requests that the Commission withdraw the Interim-Final Rule. In the alternative, the Commission should

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[1] *Position Limits for Futures and Swaps*, 76 Fed. Reg. 71626 (Nov. 18, 2011) [hereinafter *Position Limits Rule*].

[2] Pub. L. No. 111-203 (2010).

[3] *Position Limits Rule*, *supra* note 1, at 71638. CEA Section 4a(a)(3)(B) requires that position limits established by the Commission must, to the maximum extent practicable, (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.

appropriately increase the spot-month limit for cash-settled contracts to reflect the fact that they do not pose a significant risk of market manipulation. Additionally, given the substantial compliance and reporting burdens that the rule imposes on end-users, EEI respectfully requests that the Commission apply the aggregation requirement to require aggregation of cash-settled contracts only where there is common control over trading decisions.

I. Description of EEI's Interest in the Interim-Final Rule.

EEI is the association of U.S. shareholder-owned electric companies. EEI's members serve 95 percent of the ultimate customers in the shareholder-owned segment of the U.S. electricity industry, and represent approximately 70 percent of the U.S. electric power industry. EEI also has more than 65 international electric companies as Affiliate members, and more than 170 industry suppliers and related organizations as Associate members.

EEI's members are not financial entities. Rather, they are physical commodity market participants that rely on swaps primarily to hedge and mitigate their commercial risk. Regulations that make effective risk management options more costly for end-users of swaps will likely result in higher and more volatile energy prices for retail, commercial, and industrial customers. As end-users of commodity swaps to hedge commercial risk, EEI's members have a direct and significant interest in when and to what extent the Commission exercises its authority to establish speculative position limits, and the related regulations governing the *bona-fide* hedging transactions and aggregation of positions.

II. Summary of EEI's Comments.

EEI respectfully submits that the Commission does not yet have sufficient information to make the finding required by Section 4a(a)(1) of the Commodity Exchange Act ("**CEA**"), as amended, that position limits on cash-settled contracts are "necessary to diminish, eliminate, or prevent" excessive speculation in a commodity. Accordingly, the Commission should withdraw the Interim-Final Rule until it has the information necessary to determine if it can make such a finding.

The primary purpose of position limits is to prevent traders from manipulating prices by artificially controlling the deliverable supply of the underlying commodity. Cash-settled contracts do not pose a risk of price manipulation because they do not confer on cash-settled contract counterparties any delivery rights or obligations – the cash-settled contract is responsive primarily to prices that are set in the spot- and physical-delivery market.

If the Commission nevertheless elects to retain the Interim-Final Rule, EEI requests that the Commission revise the following aspects of the Interim-Final Rule to minimize the potential burdens that it will impose on end-users of cash-settled futures and swaps contracts:

- establish position limits for cash-settled contracts based not on the "deliverable supply" of an underlying commodity, but on the relative liquidity of the cash-settled markets;

- require aggregation of cash-settled contract positions only where there is common control over trading decisions and reinstate a modified version of the aggregation exemption for owned non-financial entities; and

- clarify the aggregation exemption for violations of federal law.

III. The Commission Should Withdraw The Interim-Final Rule Until It Has the Information Required to Determine If It Can Make A Finding That Position Limits for Cash-Settled Contracts Are "Necessary" To Prevent "Excessive Speculation."

The Commission should withdraw the Interim-Final Rule until it has the information that will enable it to determine if it can make a finding that position limits for cash-settled contracts are necessary to prevent excessive speculation and market manipulation.[4] Under CEA Section 4a(a)(2), as amended by the Dodd-Frank Act, the Commission has the authority to establish, "as appropriate," limits on speculative positions in derivatives contracts that are "necessary to diminish, eliminate or prevent" the burden on interstate commerce caused by excessive speculation (*i.e.*, by commodity price fluctuations that are sudden, unreasonable, or unwarranted).[5] Only after the Commission has made a finding that position limits are necessary does the Dodd-Frank Act direct the Commission to set limits "as appropriate" and to ensure that these limits, "to the maximum extent practicable," (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.[6]

The Commission has interpreted CEA Section 4a(a)(2) in a manner that does not require it to make a finding that "excessive speculation" exists or is likely to occur, or to find that position limits are necessary to prevent sudden or unreasonable fluctuations or unwarranted changes in prices. Instead, the Commission has stated, incorrectly in our view, that "Congress

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[4] EEI believes that the CEA requires the Commission to make such a finding with respect to position limits in all Core Referenced Futures Contracts, not only with respect to cash-settled contracts. *See* Richard F. McMahon & Dan Dolan, Letter to David A. Stawick, Secretary of the Commission, Regarding Comments on Proposed Rule Regarding Position Limits for Derivatives (RIN 3038-AD15 and 3038-AD16) at 7-9 (March 28, 2011).

[5] CEA § 4a(a)(2).

[6] CEA § 4a(a)(3).

did not give the Commission a choice,"[7] and that "the Commission must set position limits prophylactically, according to Congress' mandate in section 4a(a)(2)…"[8]

EEI is concerned by the Commission's position that it does not need to make a finding that position limits for cash-settled contracts are "necessary." The Commission's interpretation of its authority to impose position limits "prophylactically" is not supported by the language of CEA Section 4a(a)(1), which expressly states that "the Commission shall . . . fix such limits . . . *as the Commission finds are necessary* to diminish, eliminate, or prevent such burden."[9] CEA Section 4a(a)(1) does not authorize the Commission to fix position limits prophylactically and Congress, by directing the Commission to establish limits "as appropriate," did not mandate the imposition of position limits in the absence of a finding that they are necessary. CEA Section 4a(a)(1) manifestly *requires* the Commission to make a finding that position limits are "necessary." As Commissioner O'Malia noted in his dissent to the rule:

> Congress, in repeatedly qualifying its mandates with the phrase 'as appropriate' and by specifically referring back to the Commission's authority to set position limits as proscribed in section 4a(a)(1), clearly did not relieve the Commission of any requirement to exercise its expertise and set position limits only to the extent that it can provide factual support that such limits will diminish, eliminate or prevent excessive speculation.[10]

EEI respectfully submits that the Commission lacks the statutory authority to set, and therefore should not set, position limits on cash-settled contracts in the absence of a finding that they are necessary to prevent "excessive speculation" and manipulation. Because the Commission does not articulate any factual basis or substantive analysis to support the proposition that position limits on cash-settled contracts are "necessary to diminish, eliminate or prevent" excessive speculation, or are otherwise "appropriate,"[11] the Commission is not statutorily authorized to establish limits on cash-settled contracts.

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[7] *Position Limits Rule*, *supra* note 1, at 71628.

[8] *Id.* at 71627.

[9] CEA § 4a(a)(1) (emphasis added).

[10] *Position Limits Rule*, *supra* note 1, at 71701.

[11] *See*, *e.g.*, Opening Statement of Commissioner Michael Dunn at Commission Public Meeting on Final Rules Under the Dodd-Frank Act, October 18, 2011 ("To be clear, no one has proven that the looming specter of excessive speculation in the futures markets we regulate even exists. . . . I am still left with the conclusion that no one has presented to this agency any reliable economic analysis to support either the contention that excessive speculation is affecting the markets we regulate or that position limits will prevent excessive speculation."); Interim Report on Crude Oil, Interagency Task Force on Commodity Markets, at p. 5 (Jul. 2008) ("[speculators have] not resulted in systematic changes in price" . . . [on the contrary, there is evidence] suggesting instead that their positions might have provided a buffer against volatility-inducing shocks."); Staff Report on Cotton Futures and Options Market Activity During the Week of March 3, 2008 (Jan. 4, 2010); the Report on Large Short Trader Activity in the Silver Futures Market (May 2008).

At present, the Commission is ill-equipped to make such a finding, particularly with respect to cash-settled contracts. The Commission did not have comprehensive data regarding the cash-settled markets when it issued the Interim Final Rule. Indeed it did not begin receiving large trader position data for cleared swaps until November 21, 2011.[12] It will not receive substantial data on OTC swap positions until swap dealers begin reporting their positions sometime later this year. It is difficult to understand how the Commission's limits on cash-settled contracts can reasonably be designed to prevent excessive speculation when, at the time the limits were adopted, the Commission knew neither the size of the markets nor the size of the positions of market participants actively trading in them. As Commissioner O'Malia correctly pointed out:

> [W]ithout empirical data, we cannot assure Congress that the limits we set will not adversely affect the liquidity and price discovery functions of affected markets. The Commission will have significant additional data about the over-the-counter (OTC) swaps markets in the next year, and at a minimum, I believe it would be appropriate for the Commission to defer any decisions about the nature and extent of position limits for months outside of the spot month, including any determinations as to appropriate formulas, until such time as we have had a meaningful opportunity to review and assess the new data and its relevance to any determinations regarding excessive speculation.[13]

EEI is concerned that the rule will make hedging more expensive for its members because the rule may cause a decrease in market liquidity and will significantly increase compliance and reporting costs for *bona fide* hedgers. Commissioner Dunn noted that, for "farmers, producers, and manufacturers, position limits, and the rules that go along with them, may actually make it more difficult to hedge the risks they take on in order to provide the public with milk, bread, and gas. . . . Position limits may actually lead to higher prices for the commodities we consume on a daily basis."[14] Accordingly, EEI requests that the Commission withdraw the Interim-Final Rule until it has the information required to determine if it can make a finding that position limits on cash-settled contracts are, in fact, "necessary" to prevent "excessive speculation."

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[12] The Final Rule regarding Large Trader Reporting for Physical Commodity Swaps went into effect for clearing firms and clearing organizations on November 21, 2011. *Large Trader Reporting for Physical Commodity Swaps*, 76 Fed. Reg. 43851 (July 22, 2011) (Final Rule); *see also* Press Release, Commission's Division of Market Oversight Issues Letter to Market Participants Requiring Compliance with New Large Trader Reporting System for Physical Commodity Swaps and Swaptions (Nov. 18, 2011). Prior to that time, the Commission could exercise its "special call" authority pursuant to Commission Rule 18.05 to require traders to provide information concerning their positions, transactions, or activities. *See* 17 C.F.R. § 18.05.

[13] *Position Limits Rule*, *supra* note 1, at 71702.

[14] Opening Statement of Commissioner Michael Dunn at Commission Public Meeting on Final Rules Under the Dodd-Frank Act, October 18, 2011.

IV. Cash-Settled Contracts Should Not Be Subject To Position Limits Because They Do Not Present A Significant Risk Of Market Manipulation.

A. The Commission Should Perform A Detailed Economic Analysis Of The Market For Cash-Settled Contracts Before Imposing Position Limits.

Historically, Commission staff has engaged in a detailed economic analysis before recommending that position limits be imposed on particular commodities. In 1977 the Office of the Chief Economist prepared a report for the Commission, *Speculative Limits* ("the **1977 Report**"), examining the issue of position limits, including (1) whether there should be limits and for what groups of commodities, (2) what limits should be imposed, and (3) whether the Commission or the exchanges should set the limits.[15] The 1977 Report identified 10 factors that the Commission should consider when evaluating whether large positions in a particular market have the ability to impact price such that position limits should be imposed, including the liquidity of the cash and futures markets in the relevant contract and the characteristics of the commodity underlying a contract, such as its breadth of supply, transportation costs, ease of delivery, and storability.[16] The 1977 Report recommended that, "[t]he Commission [should] adopt a policy of establishing speculative limits in those markets where the characteristics of the commodity, its marketing system, and the contract lend themselves to undue influence from large scale speculative positions."[17] In 1980, when the Commission first proposed requiring the exchanges to set position limits for all futures contracts not currently subject to Commission imposed limits, the Commission extensively cited the 1977 Report's analysis regarding when position limits were necessary.[18] Further, the Commission stated that it would perform its own detailed review of each limit proposed by the exchanges and noted its expectation that the exchanges would "employ their knowledge of their individual contract markets" as they set position limits.[19]

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[15] *Speculative Position Limits*, 45 Fed. Reg. 79631, 79832 (Dec. 2, 1980) [hereinafter *1980 Proposed Rule*] (describing the purpose of the 1977 Report at page 1).

[16] *See* Staff Report, Office of the Chief Economist, Commodity Futures Trading Commission, *Speculative Limits* at 2, 19 (June 23, 1977) [hereinafter *1977 Report*].

[17] *1980 Proposed Rule, supra* note 15, at 79832 (quoting from the 1977 Staff Report at page 5).

[18] *Id.*

[19] *Establishment of Speculative Position Limits*, 46 Fed. Reg. 50938, 50940 (Oct. 16, 1981) [hereinafter *1981 Final Rule*] (noting that the Commission would evaluate an exchange's proposed position limit by "consider[ing] the historical distributions of speculative positions considering, among other things, recent trends in position patterns, the frequency of positions occurring at different levels and the preponderance of speculative positions normally observed in the market").

Thus, when the Commission has considered whether to impose position limits in the past, it has recognized the importance of evaluating the unique characteristics of contracts, commodities, and markets that would enable a trader to acquire a sufficiently large position to influence price. A thorough economic analysis of the attributes of cash-settled contracts according to the criteria of the 1977 Report reveals that they pose little to no risk of market manipulation. Accordingly, cash-settled contracts should not be subject to position limits. Alternatively, in the event the Commission elects to retain position limits for cash-settled contracts, the limits should be increased to reflect the fact that cash-settled contracts do not present a significant risk of market manipulation.[20]

The finite physical supply of a commodity does not impact the ability of counterparties to a cash-settled contract to perform their respective settlement obligations (because settlement occurs in cash), and, consequently, liquidity in the cash-settled contract does not decrease towards expiration of the contract.[21] Furthermore, transactions in cash-settled contracts settle against prices of spot and physically-settled futures transactions in a commodity – *i.e.*, price discovery for a commodity does not occur in the cash-settled derivatives market for the commodity, but rather in the physical delivery market. As such, cash-settled contracts are inherently less susceptible to price disruptions and manipulation than physically-settled contracts.[22]

B. The Commission's Rationale For Establishing Parity Between Cash-Settled And Physically-Settled Contracts Lacks Factual Support.

In the Interim-Final Rule, the Commission does not engage in economic analysis as to the need for position limits on cash-settled contracts; the Commission merely asserts that a one-to-

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[20] The Commission has requested comment as to whether (1) other metrics or criteria may be relevant to setting spot-month limits on cash-settled contracts; and (2) the Commission should consider the relationship between open interest in cash-settled contracts and open-interest in the physical-delivery contract in the spot month. *Position Limits Rule*, *supra* note 1, at 71638.

[21] Generally, in the spot-month, the performance and settlement obligations of physically-settled futures and cash-settled swaps differ greatly *precisely because of the physical delivery characteristic of physically-settled futures*. In the spot-month, towards expiration of a physical-delivery contract, deliverable supply will decline as a natural consequence of completed deliveries. Liquidity constraints in a physical-delivery contract may arise where a physical delivery contract experiences reductions in open interest due to certain market participants exiting the contract (because, perhaps, of their inability to make or take delivery), which may result in other traders in the contract holding a dominant share of either the contract open interest, deliverable supply, or both.

[22] Jones, F.J., "The Economics of Futures and Options Contracts Based on Cash Settlement," 2 Journal of Futures Markets 63, 69 (1983) ("Because the cash settlement mechanisms does not require actual delivery, cash settlement may reduce if not entirely eliminate the potential for squeezes on the futures contract."); Garbade, Kenneth and W. Silber, "Cash Settlement of Futures Contracts: An Economic Analysis," 3 Journal of Futures Markets 451, 455 (1983) ("[B]ecause the futures contract neither allows nor requires physical delivery, squeezes and dumping vanish and local cash market prices of deliverable grades will not diverge from the commercial value of the commodity.").

one ratio between spot-month limits on physical-delivery and cash-settled contracts is necessary to deter excessive speculation."[23] The Commission explained that it did not adopt higher, conditional spot-month limits for cash-settled contracts as proposed in the Proposed Rule because "[permitting] larger position[s] in look-alike cash-settled contracts [] *may provide an incentive to manipulate* and undermine price discovery in the underlying physical-delivery futures contract."[24]

The Commission's rationale for establishing parity between cash- and physically-settled contracts lacks factual support. Where traders have the ability to transact in a commodity in multiple different markets (whether spot, physically-delivered futures, or cash-settled) arbitrage opportunities between such markets will result in the price for the commodity becoming highly correlated, which tends to enhance liquidity and price discovery in the market for the commodity, and which makes position limits less necessary to deter "excessive speculation."[25] In addition, where there is a strong correlation between cash-settled and physically-settled markets, which generally is the case because price discovery for cash-settled commodity contracts typically occurs in the spot or physical delivery futures market, it is extremely difficult (and perhaps impossible) for a trader with a large position in the cash-settled market to exercise abusive market power in the physically-settled or spot market because physical, futures, and swaps markets will operate, for purposes of price discovery, as a single market. Therefore, where position limits exist in a physical-delivery contract, the close correlation between prices in the physical-delivery and cash-settled markets will further reduce the need to also impose position limits in the cash-settled market.

C. The Liquidity Characteristics of Cash-Settled Contracts Make Them Less Susceptible To Manipulation Than Physically-Settled Contracts.

In the release notes to the rule, the Commission suggests that comparable size of the markets for cash- and physically-settled contracts makes the two markets equally as susceptible

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[23] *Position Limits Rule*, *supra* note 1, at 71636. The Commission has sought comment on whether the one-to-one ratio between cash-settled and physical-delivery contracts is appropriate.

[24] *Id.* at 71635 (emphasis added). In the Notice of Proposed Rulemaking regarding Position Limits for Derivatives (the "**Proposed Rule**"), the Commission set a conditional spot-month position limit for cash-settled contracts that was five times the spot-month limit for physically-settled contracts, provided certain other conditions were met. *Position Limits for Derivatives*, 76 Fed. Reg. 4752, 4758 (Jan. 26, 2011) [hereinafter *Proposed Rule*].

[25] In its 1977 Report, the Commission found that "arbitrage, if it exists to any appreciable degree, causes the cash and futures markets to be highly interrelated, thus limiting the potential for a large position in the futures to influence price levels." *1977 Report*, *supra* note 16, at 19-20 (describing the effects of arbitrage between the cash spot markets and futures markets); *1980 Proposed Rule*, *supra* note 15, at 79833 ("The Commission recognizes that certain characteristics of a commodity and liquidity in the cash and futures markets tend to promote arbitrage between cash and futures and may limit the potential for large positions to influence price.").

to manipulation.[26] The Commission essentially uses the "size" of the markets in cash- and physically-settled contracts as a gauge of the liquidity characteristics of the two contracts – but this misapprehends the significantly different liquidity characteristics of cash-settled contracts versus physically-settled contracts. The susceptibility of a commodity market to manipulation is not determined by its "size," but rather by the ability of a trader to constrain the supply of a physical commodity due to a dominant position, *which gives the trader control over physical deliveries* of the commodity. Consequently, the risk of market manipulation in the cash-settled markets is much lower than in the physical-delivery markets, because no such control over the physical supply exists.

Unlike physical delivery markets, the actual "size" of cash-settled markets is potentially unlimited because an infinite number of cash-settled positions can be priced off of any given quantity of physically-settled positions. As a result, the cash-settled market has the potential to be many times larger than the physically-settled market, making cash-settled markets inherently more liquid and less susceptible to manipulation than physically-settled markets.

Additionally, as noted above, cash-settled contracts typically do not impact the settlement price of physically-settled contracts. On the contrary, cash-settled contracts generally derive their price directly from their physically-settled counterparts in the spot market.[27] Because control of supply of a commodity can only be gained through a position in the physical-delivery market, a trader's position in the cash-settled market does not by itself confer on the trader the ability to influence prices in the underlying physical commodity.

In the spot-month, towards expiration of a physically settled-contract, a cash-settled contract priced off of its physically-settled counterpart may maintain high liquidity, even if its physically-settled counterpart does not. Traders in the cash-settled contract do not exit the trade due to an inability to perform settlement obligations. Parties to physical-delivery contracts face maturing physical delivery rights and obligations and must prepare to make and take delivery; these rights and obligations act as a deterrent to further transactions in the physical-delivery market towards expiration of the contract, which constrains liquidity and increases the risk of

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[26] The Commission does not engage in an analysis of the liquidity, or "size," of the cash-settled market, but merely notes that, based on "administrative experience, available data, and trade interviews" it believes that the size of the markets in cash-settled contracts in agricultural, metals, and energy commodities (other than natural gas) were not materially larger, and in some cases smaller than, the markets for physical-delivery contracts. *Position Limits Rule*, *supra* note 1, at 71635.

[27] JOHN C. HULL, OPTIONS, FUTURES, AND OTHER DERIVATIVES 36 (2007) (noting that a cash-settled contract's "[f]inal settlement price is set equal to the spot price of the underlying asset at either the opening or close of trading on" the day the contract is declared closed); PHILIP MCBRIDE JOHNSON & THOMAS LEE HAZEN, DERIVATIVES REGULATION 146-47 (2004) ("[w]hen there exists an active spot market disseminating regular and reliable prices, the obligations of parties in the futures market could be settled in cash at the end of the contract on the basis of those spot prices.").

market manipulation due to large positions in the physical-delivery contract. These liquidity constraints do not exist in the market for cash-settled contracts.[28]

D. DCM Core Principles Treat Cash-Settled Contracts As Posing A Low-Risk Of Market Manipulation.

Historically, the Commission's Core Principles for designated contract markets ("**DCMs**") have recognized the significantly lower risk of market manipulation associated with cash-settled contracts as compared to their physically-settled counterparts.[29] Core Principle 5 of the Commission's DCM regulations, like the Commission's instruction under section 4a(a)(2) to set limits "as appropriate," requires DCMs to adopt position limits or position accountability provisions where "necessary and appropriate."[30] Specifically, Core Principle 5(b)(2) currently provides that:

> In general, ***position limits are not necessary*** for markets where the threat of excessive speculation or manipulation is nonexistent or very low. Thus, contract markets do not need to adopt speculative position limits for . . . *contracts specifying cash settlement where the potential for distortion of such price is negligible*.[31]

Accordingly, Core Principle 5 requires DCMs to establish hard spot-month position limits for all physical-delivery markets equal to no more than 25 percent of the estimated deliverable supply,[32] but, with respect to cash-settled contracts, the core principle states only that "spot-month position

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[28] Commission Staff recognized the unique liquidity characteristics of financially-settled derivatives in the 1977 Staff Report, which noted that position limits would not be beneficial for currency and financial futures. Similar to cash-settled contracts, currency and financial futures are settled through cash exchanges rather than physical delivery of a commodity: "[p]osition limits would have no potential benefit for the currency and financial futures. The perfect degree of storability of the commodity, virtual infinite breadth of supply, extreme ease of delivery on the contract, arbitrage between geographically dispersed cash markets and the futures market promote a highly interdependent market system. . . . *This situation virtually precludes the potential for large speculative position to have abusive market power*." *1977 Report*, *supra* note 16, at 42 (June 23, 1977) (emphasis added).

[29] *Position Limits Rule*, *supra* note 1, at 71633 n.79.

[30] 17 C.F.R. § 38, Appendix B. In December 2010, the Commission issued a Notice of Proposed Rulemaking in response to the Dodd-Frank Act's amendment to Core Principle 5, which provides that, "for any contract that is subject to a position limitation established by the Commission pursuant to Section 4a(a) of the CEA, the DCM shall set the position limitation of the board of trade at a level not higher than the position limitation established by the Commission." *See Core Principles and Other Requirements for Designated Contract Markets*, 75 Fed. Reg. 80572, 80615 (Dec. 22, 2010).

[31] 17 C.F.R. § 38, Appendix B (emphasis added).

[32] 17 C.F.R. § 3, Appendix B. Core Principle 5 provides that "spot-month limits for physical-delivery markets are appropriately set at no more than 25 percent of the estimated deliverable supply."

limits *may* be necessary if the underlying cash market is small or illiquid . . . ."[33] Consistent with the core principle, Commission Rule 150.5 instructs exchanges to set spot-month limits for cash-settled contracts at a level "necessary to minimize the potential for manipulation or distortion of the contract's or the underlying commodity's price."[34]

While the Commission has historically recognized that cash-settled contracts should be subject to a more flexible regime due to their lower risk of market manipulation, under the Interim-Final Rule the Commission has chosen to establish strict parity between limits in cash- and physically-settled contracts without offering evidence that circumstances in the market for these contracts has changed such that more stringent requirements must be applied to cash-settled contracts in order to "diminish, eliminate, or prevent" "excessive speculation" in the commodity markets. EEI does not believe that conditions in the cash-settled markets have changed such that parity is now required or appropriate.

V. The Commission's Rationale For The Spot-Month Limit In The Henry Hub Natural Gas Contract Lacks a Sound Basis.

EEI's members rely heavily on natural gas futures and swaps to hedge electricity price risk. Thus, EEI appreciates the Commission's attempt to accord greater flexibility in position limits for the cash-settled Henry Hub Natural Gas ("**HH NG**") contract. Although EEI members are primarily hedgers, once they exceed the spot-month limit for the cash-settled HH NG contract, which is equal to five times the limit for the physical-delivery futures contract, they will be subject to the extensive reporting and compliance obligations necessary to enter into *bona fide* hedging transactions under the rule.[35] Given that the cash-settled HH NG contract is both active and highly liquid, EEI believes the Commission should eliminate the spot-month limit, or in the alternative, increase the limit to a level appropriately reflecting market conditions, to avoid subjecting EEI's members to unnecessary compliance costs.[36]

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[33] 17 C.F.R. § 38, Appendix B (emphasis added); *Proposed Rule*, *supra* note 24, at 4757-58 ("For cash-settled contracts, staff evaluates the information supplied by the exchanges and independently assesses the nature for the market underlying the cash-settlement calculation, including the depth and breadth of trading in that market, to determine the ability of a trader to exert market power and influence the cash-settlement price, with the aim of having a spot-month limit level that effectively limits a trader's incentive to exercise such market power.").

[34] 17 C.F.R. § 150.5(b).

[35] The Commission acknowledges that "there may be significant costs (or foregone benefits) associated with the implementation of the new statutory definition of bona fide hedging to the extent that the restricted definition of bona fide hedging may require trader to potentially adjust their trading strategies." *Position Limits Rule*, *supra* note 1, at 71677.

[36] The Interim-Final Rule requests comment on whether a higher ratio should apply to particular commodities. *Position Limits Rule*, *supra* note 1, at 71638.

EEI is concerned with the manner in which the Commission established the spot-month limit for HH NG contracts. The Commission's rationale for the heightened limit for the HH NG contract is that the cash-settled markets for natural gas are "sufficiently different from the cash-settled markets in other physical commodities to warrant a different spot-month limit methodology."[37] The Commission makes no finding that "excessive speculation" exists in the HH NG contract, and, indeed, suggests that price discovery in the HH NG contract has generally functioned smoothly and that the market is "very active."[38] It is thus unclear why the Commission has elected to impose a limit on the HH NG contract.

As discussed above, under the CEA, before imposing position limits, the Commission is required to make a finding that such limits are <u>necessary</u> to prevent "excessive speculation" and market manipulation. Even if the Commission were to find that "excessive speculation" in fact exists in the market for the HH NG contract, it is not clear that setting the position limit for that contract at five-times the comparable physical-delivery limit would prevent or diminish "excessive speculation." Indeed, without market data or economic analysis, it is impossible to know whether a limit is needed and what an appropriate limit might be. Consequently, the use of the five-times multiple for the limit applicable to the cash-settled HH NG contract appears to both lack a factual basis and be inconsistent with the Commission's mandate under the CEA.[39]

Furthermore, establishing position limits in this manner creates significant uncertainty for market participants. The Commission is required to periodically re-evaluate limits and modify them in light of changes to "deliverable supply" calculations by exchanges. Without a finding that limits on cash-settled HH NG contracts are necessary to prevent "excessive speculation," HH NG cash-settled contracts should not be subject to any limits. The Commission should establish limits only after it has engaged in a thorough economic analysis of the market in the HH NG contract to determine the appropriate level for a limit, based on empirical evidence, that is consistent with the Commission's statutory objectives.[40] EEI members believe that, if any limit should be applied at all, a limit greater than five times the comparable limit for the physical delivery contract is likely to be appropriate, given the substantial liquidity of the market in the cash-settled HH NG contract, which the Commission itself has acknowledged.

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[37] *Position Limits Rule*, *supra* note 1, at 71635.

[38] *Id.* at 71636.

[39] *Id.* The Commission states only that exchanges have some experience with establishing a five-times multiple for certain cash-settled contracts over their physical-delivery counterparts; aside from this, it is not clear why the Commission has chosen this level.

[40] Under CEA § 4a(a)(3), position limits that are established following a finding of "excessive speculation" must, "to the maximum extent practicable," (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. *See supra* note 6 and accompanying text.

VI. "Deliverable Supply" Is An Inappropriate Measure For Establishing Position Limits For Cash-Settled Contracts.

EEI generally agrees with the Commission that deliverable supply is an appropriate measure for setting spot-month limits for physically-settled contracts because the measure gauges the susceptibility of the market to manipulation from traders that have "extraordinarily large positions" that confer a degree of control over the supply of the commodity. With respect to physically-settled contracts, "deliverable supply" essentially gives a gauge of the likelihood of a liquidity crunch in a contract arising from the limited supply of a commodity for delivery upon the expiration of the contract. In contrast, "deliverable supply" does not provide a meaningful gauge of the relative liquidity of cash-settled contracts or their susceptibility to manipulation. Because cash-settled contracts do not require the making or taking of delivery of the underlying commodity, the deliverable supply of a commodity does not give a meaningful measure of the liquidity of a cash-settled contract and its susceptibility to manipulation. The cash-settled contract is merely responsive in price to the value of the physical commodity as it is set in the spot and physical delivery markets.

Due to the fundamentally different liquidity characteristics between cash- and physically-settled contracts, the Commission should, if it chooses to retain position limits for cash-settled contracts at all, base position limits for cash-settled contracts on a meaningful measure of the relative liquidity of cash-settled markets – *i.e.*, the outstanding notional value of all transactions in the cash-settled contract that is subject to a limit.[41] In addition to more appropriately reflecting the liquidity and likelihood of manipulation in cash-settled markets, basing spot-month limits for cash-settled contracts on the outstanding notional value advances furthers the Commission's statutory objectives under the CEA.[42]

VII. The Definition Of "Deliverable Supply" Should Be Revised.

If the Commission elects to retain "deliverable supply" as the basis for determining spot-month limits for cash-settled contracts, or physical-delivery contracts, or both, EEI believes the Commission should update its definition of "deliverable supply" to reflect the complexities of contemporary commodity markets.[43] EEI believes the Commission's definition of "deliverable

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[41] The Commission has requested comment regarding metrics that are relevant to the setting of spot-month limits in cash-settled contracts. *Position Limits Rule*, *supra* note 1, at 71638.

[42] *See supra* note 40.

[43] EEI has previously provided the Commission with comments regarding the definition of "deliverable supply" under the Proposed Rule. *See* Richard F. McMahon & Dan Dolan, Letter to David A. Stawick, Secretary of the Commission, Regarding Comments on Proposed Rule Regarding Position Limits for Derivatives (RIN 3038-AD15 and 3038-AD16) at 7-9 (March 28, 2011).

supply" is unnecessarily vague.[44] The Commission should clarify that the definition of "deliverable supply" includes: (1) all available local supply (including supply committed to long-term commitments); (2) all deliverable non-local supply, (3) all comparable supply (based on factors such as product and location)[45], and (4) "exchanges for related positions" ("**EFRPs**").[46]

EFRP transactions enhance liquidity in the market, thereby reducing the potential for market manipulation, by permitting traders with a position in a physical delivery contract to exist their trade without disrupting the physical settlement process – such transactions therefore facilitate participation in the physical delivery market, which enhances liquidity. The Commission should recognize the liquidity contribution made by such alternative settlement options by expanding the definition of "deliverable supply" to include these transaction types. A well-tailored definition of deliverable supply that includes new but widely accepted alternative settlement methods will promote liquidity, encourage effective risk management, and ultimately reduce the threat of price volatility and manipulation.

VIII. The Commission Should Reevaluate Aggregation Requirements In Light Of The Unprecedented Burdens They Place On Commercial Firms.

A. Aggregation Of Cash-Settled Positions Should Be Based Solely On Control Of Trading Decisions, Not Common Ownership.

The Position Limits Rule would require an entity to aggregate all positions and accounts in which it directly or indirectly has a 10 percent or greater ownership or equity interest, regardless of whether the affiliated entities are actually subject to common control (the "**Aggregation Standard**").[47] The Aggregation Standard is a significant compliance burden for commercial firms because of the rigorous level of coordination that it requires among entities that exceed the Aggregation Standard's 10 percent common ownership threshold. Because the Interim-Final Rule establishes Commission-set position limits on cash-settled contracts for the

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[44] The Position Limits Rule appears to have adopted the Proposed Rule's definition of "deliverable supply" without change. *See Position Limits Rule*, *supra* note 1, at 71633 (quoting the proposed rule).

[45] *Position Limits Rule*, *supra* note 1, at 71733 (noting that commenters had suggested the Commission base spot-month limits on "available deliverable supply," which is a broader measure than physical supply). *See also In Re Cox*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,786 at 34,062-65 (CFTC Jul. 15, 1987) (explaining that "available deliverable supply" includes the quantity of a commodity that a market participant could procure with "prudent planning," and includes: (1) all available local supply, (2) all deliverable non-local supply, and (3) all comparable supply (based on factors such as product and location).

[46] *See Revision of Federal Speculative Position Limits*, 52 Fed. Reg. 38914 (Oct. 20, 1987). EFRPs make physical settlement of exchange-traded commodity futures and option contracts unnecessary in many circumstances, and therefore, increasingly less common; at the same time, such transactions contribute to liquidity in the market for physical-delivery contracts, making it less susceptible to manipulation.

[47] *Position Limits Rule*, *supra* note 1, at 71692.

first time, EEI respectfully requests that the Commission evaluate whether the Aggregation Standard's requirement to aggregate based on a 10 percent ownership interest is appropriate for cash-settled contracts and the firms that use them.[48]

Regardless of whether the Position Limits Rule ultimately limits a commercial firm in its ability to enter into transactions (because of the availability of *bona fide* hedging exemptions), all related commercial entities that exceed the 10 percent ownership interest threshold and that engage in transactions in Core Referenced Futures Contracts are required under the Position Limits Rule to coordinate, on a global basis, as to all aspects of any transactions in Core Referenced Futures Contracts in which they engage, regardless of whether they otherwise coordinate their activities. Consequently, the Aggregation Standard imposes significant operational challenges for end-users, requiring them to develop and maintain costly internal infrastructure mechanisms to ensure compliance.

Commercial firms may have scores or hundreds of related entities that must now coordinate as to whether, when, and how they engage in transactions in Core Referenced Futures Contracts. Gathering and processing such trading information on a daily basis, intra-day, in real-time, from related entities that may otherwise deal with one another on an arm's length basis, is a significant challenge for commercial firms. In order to avoid subjecting these end-users to unnecessary compliance costs, we urge the Commission to adopt an aggregation standard for cash-settled contracts based on common control, rather than ownership, of positions. Such a standard is consistent with the underlying rationale of the Commission's aggregation requirement and mitigates the compliance costs for end-users.

The Commission has explained that "[t]he fundamental rationale for the aggregation of positions or accounts is the concern that a single trader, through common ownership or control of multiple accounts, may establish positions in excess of the position limits and thereby increase the risk of market manipulation or disruption."[49] Where common control is not exercised between related entities, there is no risk of coordinated trading. Accordingly, if entities who exceed the 10 percent common ownership threshold are able to demonstrate that their trading operations are independently managed and controlled, the entities should not be required to aggregate their positions in cash-settled contracts.

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[48] *See Position Limits Rule*, *supra* note 1, at 71638 (requesting comment on cost and benefit considerations of the Interim Final Rule under CEA Section 15a). The Aggregation Standard has been in place since the CEA was passed in 1936, but traders did not begin utilizing cash-settled contracts until 1981 and the Commission has not sought to establish federal regulatory limits on cash-settled contracts until now. *See 1977 Report*, *supra* note 16, at 7 (noting that "the general authority to establish limits has been contained in section 4a(1) of the Act since its inception in 1936"); THOMAS A. RUSSO, REGULATION OF THE COMMODITIES FUTURES AND OPTIONS MARKETS 1-66 (1991).

[49] *Id*. at 71652.

The proposed owned non-financial entity ("**ONFE**") exemption would have ameliorated the burdens caused by requiring aggregation based solely on an ownership interest for many end-users by "allow[ing] disaggregation primarily in the case of a conglomerate or holding company that 'merely has a passive ownership interest in one or more non-financial operating companies . . . .'"[50] However, without providing market participants with advance notice, the Commission ultimately omitted the ONFE exemption from the Position Limits Rule, asserting it was not needed due to the other exemptions included in the final rule, including the independent account controller ("**IAC**") exemption.[51]

The IAC exemption allows an "eligible entity" to "disaggregate customer positions or accounts managed by an IAC from its proprietary positions" provided that the IAC trades independently of the eligible entity (and any other IAC trading for the eligible entity) and has no knowledge of trading decisions by any other IAC.[52] Thus, the IAC exemption applies in situations where an entity is able to demonstrate that, despite its ownership interest in an account, the account's trading operations are independently managed and controlled from its own trading operations, thereby removing any need for aggregation.[53] Under such circumstances, the Commission found that providing an exemption was "in accord with the purposes of the aggregation policy."[54]

Despite the fact that many commercial firms have trading operations that are managed and controlled independently from entities in which they have a 10 percent or greater ownership interest, commercial firms are not able to claim the IAC exemption due to the narrow definition of "eligible entity" under the Position Limits Rule. In the absence of the ONFE exemption,

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[50] *Id.* at 71653. The Commission included several indicia regarding independent control under the ONFE exemption, including: (1) control of trading decisions by persons employed exclusively by the ONFE, who do not in any way share trading control with persons employed by the ONFE; (2) maintenance and enforcement of written policies and procedures to preclude the ONFE or any of its affiliates from having knowledge of, or gaining access to, or receiving information or data about its positions, trades or trading strategies, including document routing and other procedures and security arrangements; and (3) maintenance of a separate risk management system from the ONFE and any of its other affiliates. *See Proposed Rule*, *supra* note 24, at 4744.

[51] Specifically, the Commission stated that in light of the Commission's decision to retain the IAC exemption, provide an exemption for Federal law information sharing restrictions, and provide an exemption for underwriting, that it was not necessary to expand the scope of disaggregation exemptions to owned non-financial or financial entities. *Position Limits Rule*, *supra* note 1, at 71654.

[52] *Id.* at 71652.

[53] The Commission explained that the IAC exemption was warranted because the concerns underlying its aggregation policy were "mitigated in circumstances involving client accounts managed under the discretion and control of an independent trader and subject to effective information barriers." *Id.* at 71652.

[54] *Position Limits Rule*, *supra* note 1, at 71652.

many of EEI's members will be forced to aggregate their positions in cash-settled contracts across commonly-owned, but not commonly controlled, entities.[55]

Accordingly, the Aggregation Standard will require many end-users to aggregate positions in cash-settled contracts with commonly-owned firms in situations where there is no risk of coordinated trading. While the Commission has provided an exemption for financial entities where independent management and control can be demonstrated, the Commission has not provided comparable relief for commercial end-users. EEI respectfully suggests that the Commission revise the Aggregation Standard to permit disaggregation with respect to cash-settled contracts where independent control of trading decisions can be demonstrated.[56] As described in previously submitted comments, EEI also requests that the Commission reinstate the ONFE exemption so that commercial firms, like their financial counterparts, are permitted to disaggregate their positions from certain commonly-owned entities in situations where there is no common control.[57]

B. The Aggregation Exemption For Violation of Law Should Be Refined And Expanded To Include Circumstances That Create a *Reasonable Risk* of a Violation of Federal or State Law.

The Position Limits Rule provides an exemption from aggregation for situations where the "sharing of information associated with such aggregation would cause either person to violate Federal law or regulations adopted thereunder [] provided that such a person does not have actual knowledge of information associated with such aggregation" (the "**Violation of Law Exemption**").[58] EEI believes the Commission should clarify that the Violation of Law Exemption covers: (1) information sharing that could create a *reasonable risk of a violation*; and (2) violations of federal *and state* laws and regulations.

The standard included in Rule 151.7(i) – information sharing that "would cause" a violation – is too high if applied literally. Note that Rule 151.7(i) imposes a requirement that entities seeking to utilize the Violation of Law Exemption must obtain an opinion of counsel

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55 *Id.* at 71653.

56 In determining whether a commercial firm's trading operations are independently managed and controlled, the Commission could establish information barrier requirements similar to those contained in the proposed ONFE exemption or the existing IAC exemption.

57 EEI requests that the ONFE exemption be reinstated with the following modifications: (1) the ONFE exemption should be effective when filed, consistent with the final IAC exemption, and (2) entities eligible for the ONFE exemption should be permitted to utilize risk management systems and personnel on an enterprise-wide basis across affiliates. *See* Richard F. McMahon & Dan Dolan, Letter to David A. Stawick, Secretary of the Commission, Regarding Comments on Proposed Rule Regarding Position Limits for Derivatives (RIN 3038-AD15 and 3038-AD16) at 7-9 (March 28, 2011).

58 17 C.F.R. § 151.7(i).

regarding whether information sharing "would cause" a violation – such opinions may prove difficult to obtain from counsel in light of the very high standards that apply to the issuance of opinions and the difficulty of meeting the high "would cause" standard. EEI therefore requests that the Commission revise the exemption standard to permit a showing that information sharing would have a *reasonable risk of resulting in a violation* of law.

EEI also requests the Commission to clarify that the Violation of Law Exemption extends to potential state law violations as well. The exemption's limited applicability to only federal law renders its relief incomplete. Indeed, the Commission noted that it was adopting the Violation of Law Exemption in light of comments received regarding the possibility that the information sharing requirements triggered by the Aggregation Standard would cause violations of other legal requirements, such as fiduciary standards and contractual obligations, both of which arise under both state and federal law. [59] The Commission did not explain why it chose to limit the Violation of Law Exemption to violations of federal law. For consistency and completeness, the Commission should clarify that the exemption covers potential violations of state law as well.

IX. Conclusion.

EEI appreciates the opportunity to comment on the Interim-Final Rule.[60] As discussed above, EEI encourages the Commission to withdraw the Interim-Final Rule, engage in a detailed economic analysis of the markets potentially affected by the rule, and, in any event, prior to imposing any position limits on any contracts under the Commission's authority under the CEA, the Commission should make a finding that position limits are "necessary" to prevent "excessive speculation." EEI also requests that the Commission give thoughtful consideration to our proposed revisions to the Aggregation Standard.

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[59] *Position Limits Rule*, *supra* note 1, at 71652.

[60] To the extent the Commission further defines "swap" in a manner that modifies materially the commonly understood meaning of this term, EEI respectfully reserves the right to amend and supplement these comments. *See* Comments of EEI filed on September 20, 2010 in response to the Advance Notice of Proposed Rulemaking regarding key definitions in the Dodd-Frank Act. Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act, 75 Fed. Reg. 51,429 (Aug. 20, 2010).

Please contact us at the number listed below if you have any questions regarding these comments.

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