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January 17, 2012

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

<u>VIA ELECTRONIC SUBMISSION</u>

Re: *Interim Final Rule on Spot-Month Position Limits,* RIN 3038-AD17

Dear Secretary Stawick:

I. <u>INTRODUCTION</u>.

On behalf of the Working Group of Commercial Energy Firms (the "Working Group"), Hunton & Williams LLP hereby submits these comments in response to the request for public comment set forth in the Commodity Futures Trading Commission's (the "CFTC" or "Commission") Final and Interim Final Rule, *Position Limits for Futures and Swaps*, which, among other things, implements spot-month position limits on an interim rule basis.[1] The Working Group has previously submitted comments on all aspects of the Commission's proposed federal position limits regime, including, but not limited to, the development of spot-month limits, the definition of *bona fide* hedging, and aggregation requirements.[2] The comments submitted herein respond specifically to the Interim Final Rule as it relates to the establishment of spot-month limits for cash-settled contracts.

The Working Group is a diverse group of commercial firms in the energy industry whose primary business activity is the physical delivery of one or more energy commodities to others, including industrial, commercial, and residential consumers. Members of the Working Group are energy producers, marketers, and utilities. The Working Group considers and responds to requests for public comment regarding regulatory and legislative developments with respect to

[1] *See Position Limits for Futures and Swaps*, Final Rule and Interim Final Rule, 76 Fed. Reg. 71,626 (Nov. 18, 2011) ("Interim Final Rule").

[2] *See Position Limits for Derivatives*, Notice of Proposed Rulemaking, 76 Fed. Reg. 4,752 (Jan. 26, 2011) ("Position Limits NOPR"); Working Group of Commercial Energy Firms, *Comments on Position Limits for Derivatives* (Mar. 28, 2011); Working Group of Commercial Energy Firms, *Comments on Spot-Month Position Limits - Conditional Exemption for Cash-Settled Contracts* (Aug. 16, 2011).

the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

The Working Group appreciates the opportunity to provide the comments set forth herein and requests the Commission's consideration of such comments in order to adopt spot-month limits that are effective, based on accurate and updated information, and workable for market participants.

II. COMMENTS OF THE WORKING GROUP OF COMMERCIAL ENERGY FIRMS.

A. THE COMMISSION SHOULD STUDY AND IDENTIFY THE SIZE OF CASH MARKETS FOR REFERENCED CONTRACTS IN ENERGY COMMODITIES TO AVOID SETTING OVERLY RESTRICTIVE SPOT-MONTH POSITION LIMITS.

As noted in its prior comments, the Working Group is concerned that the Commission will unduly constrain energy markets by setting spot-month position limits before it has fully studied and identified in empirical terms the size of cash markets for Referenced Contracts in energy and other physical commodities.[3] The imposition of inappropriately set spot-month position limits could result in significant, unintended adverse impacts on both the derivatives markets for physical commodities and underlying physical markets.

At the Commission's open meeting adopting the Position Limits NOPR, Commissioner Chilton warned that "if limits were set too low, there would be a possibility that trading migration could take place, transferring traders to over-the-counter markets or overseas exchanges."[4] The Commission in the Interim Final Rule attempts to address this concern and proposes that, after experience with the one-to-one ratio, it can revisit and evaluate the effects of the interim spot-month position limits.[5]

The Working Group respectfully submits that an after-the-fact review cannot unwind the detrimental effects that inappropriate spot-month position limits will have on the derivatives and underlying physical markets. In light of this concern, before establishing final spot-month limits, the Working Group strongly recommends that the Commission study and analyze the markets for physically delivered and cash-settled Referenced Contracts for the following energy commodities: (i) NYMEX Light Sweet Crude Oil ("CL"), (ii) NYMEX New York Harbor

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[3] *See* Working Group of Commercial Energy Firms, *Comments on Position Limits for Derivatives* (Mar. 28, 2011).

[4] *See* Commissioner Bart Chilton, Opening Statement at January 14, 2010 CFTC Open Meeting (Jan. 14, 2010), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/chitlonstatement011410.

[5] The Working Group respectfully submits that it is not clear how the spot-month limits contained in the Interim Final Rule can reasonably be expected to prevent excessive speculation as the Commission does not appear to have any empirical data quantifying the size of cash-settled markets or the number of active traders in such markets.

Heating Oil ("HO"), (iii) NYMEX New York Harbor Gasoline Blendstock ("RB"), and (iv) NYMEX Henry Hub Natural Gas ("NG").[6]

A critical step in this process must involve the development of updated, accurate deliverable supply levels for each energy commodity identified above, as these levels will set the base line for the development of appropriate spot-month limits. Another important step involves precisely determining how much activity in the cash markets constitutes speculative trading activity, as distinguished from *bona fide* hedging activity. In this regard, the Commission should address outstanding issues related to the scope and applicability of the definition of "*bona fide* hedging transaction or position" as set forth in CFTC Rule 151.5(a).[7] These steps will help the Commission to (i) develop a reasonably accurate picture of the size of the markets in which speculative trading in Referenced Contracts for energy commodities takes place, and (ii) avoid the creation of spot-month limits based on a market that incorporates hedging activity.

B. THE WORKING GROUP SUPPORTS SPOT-MONTH CLASS LIMITS FOR PHYSICALLY-DELIVERED AND CASH-SETTLED REFERENCED CONTRACTS IN ENERGY COMMODITIES AT A LEVEL NO LESS THAN A 1:5 RATIO.

The Working Group supports spot-month class limits for physically-delivered and cash-settled Referenced Contracts based on a ratio of ***not less*** than 1:5, until such time that the Commission has developed updated deliverable supply levels for the CL, HO, RB, and NG physically delivered Referenced Contracts, as well as conducted and completed its study of speculative trading activity in cash markets for these commodities. Setting the initial spot-month limits at the proposed 1:5 ratio will prevent liquidity from being artificially constrained in cash-settled markets and will avoid market adaptations that are an unintended consequence of overly restrictive limits.

As stated in the Working Group's prior comments, the Commission can always establish new spot-month limits if empirical data factually supports the establishment of spot-month limits for physically-delivered and cash-settled contracts at a more restrictive level.[8] Notably, at the CFTC opening meeting adopting the Position Limits NOPR, Commissioner Chilton stated that, while the proposed limits, which included a 1:5 ratio for spot-month limits for Referenced Contracts in energy commodities, would certainly be seen by some as higher than appropriate, should the limits prove to be inadequate, the agency could "recalibrate to ratchet them down or

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[6] In the past, the Commission has expressly recognized the importance of evaluating the unique characteristics of contracts, markets, and commodities that could allow a market participant to hold a position large enough to influence price. *See Speculative Position Limits*, 45 Fed. Reg. 79,631-32 (Dec. 2, 1980).

[7] The Working Group has identified several issues with this definition. In the near future, the Working Group will be submitting a formal petition pursuant to Section 4a(a)(7) of the Commodity Exchange Act ("CEA") requesting that the Commission grant exemptive relief and treat certain risk-reducing practices commonly used in energy markets that may not fall within CFTC Rule 151.5(a), 17 C.F.R. § 151.5(a), as *bona fide* hedging transactions or positions.

[8] Working Group of Commercial Energy Firms, *Comments on Position Limits for Derivatives* at Part III.A (Mar. 28, 2011).

even increase them *as deemed appropriate*."[9] The Working Group fully supports Commissioner Chilton's further statement that "the most important thing is to establish a thoughtful position limit system."[10]

In setting the spot-month limits for natural gas contracts at a 1:5 ratio, the Commission acknowledges that excessive speculation does not result if market participants are permitted to hold positions in cash-settled natural gas contracts five times that of the physically-delivered natural gas contracts.[11] In the absence of empirical evidence to the contrary, there does not appear to be any policy or legal reason for establishing spot-month limit ratios for the liquids markets that are different from natural gas markets. If, however, the Commission ultimately establishes initial, spot-month class limits for the CL, HO, RB, and NG markets using a more restrictive ratio than 1:5, the Working Group respectfully requests that it make available all quantifiable, empirical data supporting such action for public review and comment.[12]

C. THE 1:5 RATIO FOR SPOT-MONTH LIMITS FOR CASH-SETTLED CONTRACTS HAS EXISTED WITHOUT CAUSING DISRUPTION IN CERTAIN ENERGY MARKETS.

The 1:5 cash-settled and aggregate limits for natural gas appear to be based on the existing structure used for cash-settled, futures contracts transacted on NYMEX and significant price discovery contracts ("SPDCs") transacted on the IntercontinentalExchange, Inc. ("ICE"), which has existed without any regulatory problems or disruptions to the markets. However, the 1:5 spot-month levels for such NYMEX and ICE contracts applied only to cleared contracts.[13] It is important to recognize that there is a vast number of off-facility, cash-settled swaps that are currently not constrained by the ICE SPDC limits. These cash-settled contracts bring material liquidity to energy markets and allow market participants to hedge more precisely and efficiently their exposure to final settlement price risk.

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[9] *See* Commissioner Bart Chilton, Opening Statement at January 14, 2010 CFTC Open Meeting (Jan. 14, 2010), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/chitlonstatement011410.

[10] *Id.*

[11] *See* Interim Final Rule at 71,637 ("The Commission believes that, based on current experience with existing DCM and exempt commercial market ('ECM') conditional limits, the one-to-five ratio for natural gas contracts maximizes the statutory objectives, as set forth in section 4a(a)(3)(B) of the CEA, of preventing excessive speculation and market manipulation, ensuring market liquidity for bona fide hedgers, and promoting efficient price discovery.").

[12] While the Commission states in the Interim Final Rule that "administrative experience, available data, and trade interviews indicate that the sizes of the markets in cash-settled Referenced Contracts . . . are likely to be no greater in size than the related physical-delivery Core Referenced Futures Contracts," specific, empirical evidence and studies are needed to establish the basis for setting spot-month limits at a ratio more restrictive than 1:5. Similarly, the Working Group believes that the Commission should publicly provide empirical data and evidence to support the Commission's contention that "such [interim] limits ensure market liquidity for bona fide hedgers and protect price discovery, while deterring excessive speculation and the potential for market manipulation, squeezes, and corners." *See* Interim Final Rule at 71,636.

[13] *See, e.g.,* CME GROUP, NYMEX RULEBOOK, Rule 599.F (Conditional Limit in NYMEX Last Day Financial Natural Gas Contracts); ICE U.S. OTC COMMODITY MARKETS, LLC. REGULATORY RULEBOOK FOR SIGNIFICANT PRICE DISCOVERY CONTRACTS, Rule 6.01(Henry LD1 Fixed Price).

If cash-settled markets for Referenced Contracts in CL, HO, RB and NG are unduly constrained by spot-month limits that do not accurately reflect the level of excessive speculative activity in such markets (if any), market adaptations will most certainly occur with consequences that cannot be fully known today. In the absence of empirical evidence that suggests that a ratio lower than the proposed 1:5 ratio between physically-delivered and cash-settled Referenced Contracts for CL, HO, RB, and NG is needed, the Commission should act cautiously and avoid adopting overly restrictive limits. Any action to the contrary would be inconsistent with the underlying statutory objectives of CEA Section 4a(a)(3), as it would harm liquidity in energy markets and likely result in disruptive market behavior in physical energy markets.[14]

III. CONCLUSION.

The Working Group supports appropriate regulation that brings transparency and stability to the swap markets in the United States. The Working Group appreciates this opportunity to provide comments on the Interim Final Rule and respectfully requests that the Commission consider the comments set forth herein as it develops a final rule in this proceeding.

If you have any questions, please contact the undersigned.

Respectfully submitted,

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[14] Specifically, CEA Section 4a(a)(3) states that the Commission shall establish position limits, in its discretion, "(i) to diminish, eliminate, or prevent excessive speculation . . . ; (ii) to deter and prevent market manipulation, squeezes, and corners; (iii) to ensure sufficient market liquidity for bona fide hedgers; and (iv) to ensure that the price discovery function of the underlying market is not disrupted."