MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

February 9, 2014

Via Electronic Submission: http://comments.cftc.gov

Melissa D. Jurgens
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: RIN 3038-AD99, Position Limits for Derivatives

Dear Ms. Jurgens:

Managed Funds Association[1] ("**MFA**") appreciates the opportunity to provide comments to the Commodity Futures Trading Commission (the "**Commission**" or "**CFTC**") on its notice of proposed rulemaking to modify the Commission's position limits rules (the "**NPRM**").[2] MFA has carefully reviewed the NPRM and is offering its comments to assist the Commission in its efforts to draft final rules that balance the Commission's objectives with legitimate industry concerns.

MFA members rely on fair, competitive and transparent markets that respond to fundamental market factors to conduct their businesses. MFA members play a vital role in the derivatives industry by assuming price risk from commercial participants (hedgers) on the long and short sides of the market, and providing the liquidity that facilitates price discovery and risk transfer for businesses around the world. Our members participate in the marketplace when they trade futures and swaps and when they invest in other financial entities or institutions and

[1] Managed Funds Association (MFA) represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, the Americas, Australia and many other regions where MFA members are market participants.

[2] Position Limits for Derivatives, 78 Fed. Reg. 75,680 (proposed Dec. 12, 2013).

operating companies.[3] Accordingly, MFA members are interested in the impact the Commission's new position limits regime will have on them and their investors.

The Commission has previously published two notices of proposed rulemaking related to the imposition of position limits on derivatives. The first such notice was issued in response to energy price volatility and was subsequently withdrawn (the "**January 2010 Notice**").[4] The second notice was issued, and the rules were adopted, in 2011, but ultimately the rules were vacated by the D.C. District Court (the "**Vacated Rules**").[5] MFA commented on both rulemakings. In MFA's comment letter on the January 2010 Notice, we expressed several broad concerns about the proposed position limits, including that (i) research and experience demonstrate that position limits have not reduced price volatility or prevented market manipulation, and it was not clear how the proposed federal limits would achieve their intended purpose with respect to energy markets; (ii) proposed federal limits likely will result in decreased market liquidity, which in turn would impair the ability of commercial market participants to hedge against rising prices; (iii) restricting trading on U.S. futures markets may drive trading overseas, reducing the competitiveness of U.S. markets; (iv) the costs of the proposed federal limits far outweighed the benefits; (v) the Commission underestimated the number of affected parties, the costs to the market of compliance with the proposed rules and the potential unintended consequences; and (vi) the Commission should have considered the availability of alternative approaches.[6]

MFA's comment letter on the Vacated Rules reiterated our concerns articulated in our comment letter on the January 2010 Notice, and we further commented on the adverse effects of basing position limits on a percentage of deliverable supply, including the unnecessary

[3] For example, some of MFA's members invest in non-financial operating companies whose businesses involve the production, refining, merchandising or processing of energy and entities engaged in the development of energy market infrastructure (such as production, transportation or storage of energy), and thus have an interest in enabling such entities to access liquid price discovery and risk-shifting markets. MFA's members also may invest in financial institutions, whose businesses may involve the use of the futures markets for risk management purposes.

[4] Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations, 75 Fed. Reg. 4,144 (proposed Jan. 26, 2010), withdrawn 75 Fed. Reg. 50,950 (Aug. 18, 2010).

[5] Position Limits for Derivatives, 76 Fed. Reg. 4,752 (proposed Jan. 26, 2011); Position Limits for Futures and Swaps, 76 Fed. Reg. 71,626 (adopted Nov. 18, 2011); vacated by *International Swaps and Derivatives Association v. U.S. Commodity Futures Trading Commission*, 887 F.Supp.2d 259 (D.D.C. 2012).

[6] Letter from Richard H. Baker, President and CEO, Managed Funds Association, to David A. Stawick, Secretary, Commodity Futures Trading Commission (Apr. 26, 2010), *available at* http://www.managedfunds.org/downloads/MFA%20CFTC%20energy%20spec%20limits.4.26.10.pdf [hereinafter "MFA 2010 Comment Letter"]. In the MFA 2010 Comment Letter, we also provided a number of specific comments on the January 2010 Notice, including (a) the negative effects of the proposed "crowding out" provision in the spot month; (b) the need to preserve the existing disaggregation relief for independently controlled accounts; (c) the need for greater transparency in the calculation of open interest and deliverable supply; (d) flaws in the methodology for annual recalculation of position limits; and (e) the advisability of an exemption for inter-commodity spread transaction. *Id*.

constraints on legitimate risk management activities within the cash-settled contract in the spot month that arise from (i) the presupposition that cash-settled contracts are fungible with physically-delivered contracts (which they are not); (ii) the use of an improper calculation that is tied to a specific deliverable point without considering that some hedgers use certain contracts not intending to make or take delivery at the specific delivery location; and (iii) the failure to consider seasonal fluctuations or trends in volume in re-calculating estimated deliverable supply.[7] We also noted our belief that the conditional cash-settled limit, which would be set at five times the spot month limit for those not holding any physically-settled contracts, likely would result in increased price volatility on the last day of trading.[8]

As the Commission again considers imposing federal position limits on physical commodity derivatives, we respectfully urge it to gather and examine carefully all relevant data and consider less onerous alternatives. Rulemaking related to position limits should be empirically driven and not a response to popular sentiment or partial analyses. The Commission itself noted that the studies on position limits "show a lack of consensus regarding the impact of speculation on commodity markets and the effectiveness of position limits."[9] In the NPRM, the Commission explains that it has based its determination that position limits are necessary on a minority of Commission-reviewed reports that support position limits, seemingly disregarding the other reports because those "[s]tudies that militate against imposing any speculative position limits" conflict with the Commission's understanding of what it believes to be a statutory mandate to implement position limits.[10] We believe the Commission has misinterpreted the statutory requirement of the Commodity Exchange Act ("**CEA**") and has not made an adequate finding with respect to the necessity of imposing position limits as further discussed in our letter.

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[7] Letter from Richard H. Baker, President and CEO, Managed Funds Association, to David A. Stawick, Secretary, Commodity Futures Trading Commission (Mar. 28, 2011), *available at* http://www.managedfunds.org/wp-content/uploads/2011/06/3.28.11-MFA_Position_Limits_final.3.28.pdf [hereinafter "MFA 2011 Comment Letter"]. In the MFA 2011 Comment Letter, we also commented on the negative impact of the disaggregation relief, which would (i) too narrowly limit the ability to obtain such relief by eliminating the independent account controller exemption and replacing it with an owned non-financial entity exemption, and (ii) require an unnecessary application, approval and annual renewal exemption process inconsistent with operations of traders, especially passive traders, whom may not know of a position limits violation until after the filing deadline. MFA has commented on the Commission's separate rulemaking on aggregation of positions. *See* Letter from Stuart J. Kaswell, Executive Vice President & Managing Director, General Counsel, Managed Funds Association, to Melissa D. Jurgens, Secretary, Commodity Futures Trading Commission (Feb. 7, 2014). The MFA 2011 Comment Letter also discussed the adverse effects of the (1) elimination of inter-commodity exemptions, which would inhibit standard investment practices used to capture inefficiencies between two commodities; (2) application of single month and all-months-combined limits to each class (futures and swaps) individually with no ability to net across classes; (3) lack of more specific information related to significant price discovery contracts that would be linked to referenced contracts, the rounding up to the nearest 100 contracts and the lack of hypothetical examples that demonstrate the application of the proposed position limits rules.

[8] MFA 2011 Comment Letter.

[9] Position Limits for Derivatives, 78 Fed. Reg. at 75,965.

[10] *Id*.

Nevertheless, MFA endeavors to work with the Commission in enhancing the proposed rules without compromising the integrity and vitality of the derivatives markets.

I. EXECUTIVE SUMMARY

MFA has carefully considered the NPRM and is providing its comments and recommendations, which are summarized as follows:

A. The Commission's necessity finding falls short of the statutory requirement, reinforced by the D.C. District Court's holding in *ISDA v. CFTC*, to make such a finding before imposing position limits. The Commission limits its necessity finding, incomplete as it is, to silver and natural gas, but it has proposed position limits on 28 core referenced futures contracts and all related referenced contracts. Further, the Commission's proposed limits do not strike the right balance amongst the prescribed statutory goals of diminishing excessive speculation and deterring market manipulation, and ensuring sufficient market liquidity for *bona fide* hedgers and the price discovery function of the underlying market.

B. The Commission's proposed rules create uncertainty surrounding the determination of which contracts will be deemed to be referenced contracts, especially with respect to customized OTC swaps. We are concerned that the Commission could determine retrospectively that a particular customized OTC swap is a referenced contract despite a good faith determination by a market participant that such swap is not a referenced contract, thus exposing the market participant to potential liability. The Commission should describe the methodology it used in determining the list of contracts that staff considers to be referenced contracts to provide clarity to market participants in their analysis of customized contracts.

C. MFA supports the Commission's flexible approach to the use of option valuation models in determining the futures equivalence of options for purposes of calculating compliance with position limits. The Commission should not impose a particular option valuation model. However, in granting flexibility to market participants, the Commission must not penalize persons that use reasonable option valuation models that do not produce the same results as the Commission's models. Accordingly, MFA recommends that the Commission explicitly provide: (1) that the use of a model that produces results within 10 percent of an exchange or Commission model is presumed to be a reasonable model unless the Commission can prove otherwise, and (2) that a person whose options model deviates by more than 10 percent from an exchange or Commission model may use such model if it can demonstrate that its use is reasonable under prevailing market conditions.

D. MFA believes that the Commission should not use the same methodology for both cash-settled and physically-delivered contracts for calculating spot-month position limits. Although there may be a valid rationale for establishing spot month position limits for physically-settled contract based on deliverable supply, there is no economic rationale for linking position limits on cash-settled contracts to deliverable supply.

E. MFA urges the Commission to determine estimated deliverable supply using the most recent and reliable data that is available to it.

F. MFA does not support any limits on cash-settled contracts. Among the three alternatives presented in the NPRM though, MFA believes the second alternative to the conditional spot-month limit exemption, which sets the limit for cash-settled contracts at five times the level of the limit for the physical-delivery core referenced futures contract regardless of a trader's positions in the underlying physical-delivery contract, will best preserve price discovery and market participation.

G. MFA contends that the Commission's approach to the establishment of non-spot month and all-months-combined position limits is too simplistic in its reliance on a uniform percentage of open interest applied to all referenced contracts. This one-size-fits-all methodology does not factor in seasonal fluctuations, other fluctuations based on trends, global events or economic forces, or traders' built-in cushions for the prevention of position limits violations, which likely will result in: (1) a self-reinforcing cycle of lower position limits; (2) no flexibility to modify position limits based on liquidity needs relating to external forces; and (3) position limits that are actually different for similar contracts traded on different exchanges because such contracts have different unit sizes. Moreover, we are concerned that the inaccuracy of the swaps data that is reported to the Commission undermines the establishment of appropriate non-spot month position limit levels.

H. The Commission should clarify that a mere bid or offer or indication of interest for an OTC swap in a referenced commodity that does not constitute a binding transaction *will not* count towards a market participant's position limit or be deemed to violate a position limit.

II. THE POSITION LIMITS PROPOSAL

The NPRM would significantly change the Commission's current position limits regime. The NPRM would:

A. Establish federal position limits for certain agricultural, metals, and energy commodities contracts (defined as core referenced futures contracts). The position limits proposal imposes position limits on derivatives based on the same 28 core referenced futures contracts as were previously proposed in the Vacated Rules. Positions subject to the position limits proposal would include (1) those in the core referenced futures contracts and (2) any derivative that is directly or indirectly linked to, including being partially or fully settled on, or priced at a fixed differential to, the price of (a) that particular core referenced futures contract or (b) that same commodity underlying that particular core referenced futures contract for delivery at the same location or locations as specified in that particular core referenced futures contract, but excluding any guarantee of a swap, a basis contract or a commodity index contract.

B. Establish aggregate (i.e., aggregating futures, options, including trade options, swaps, or swaptions in each contract) spot-month position limits for core referenced futures contracts. The spot-month position limits initially would be set at the levels currently imposed by designated contract markets ("DCMs") and later at levels equal to 25% of deliverable supply, as provided to the Commission by DCMs unless the Commission decides to rely on its own estimates. The spot-month limits would be applied separately for physically delivered and cash-settled contracts.

C. Establish a conditional spot-month limit that will permit traders to acquire position levels in cash-settled contracts that are five times the spot-month limit if such positions are exclusively in cash-settled contracts and provided that the trader does not hold or control any positions in the physical-delivery referenced contract based on the same commodity that is in such contract's spot month.

   The Commission has proposed three alternatives to the conditional spot-month limit:

   1. restricting the exemption to positions in cash-settled contracts that settle to an index based on cash-market transactions prices;

   2. setting the limit for cash-settled contracts at five times the level of the limit for the physical-delivery core referenced futures contract regardless of positions in the underlying physical-delivery contract; or

3. limiting cash-settled contracts that settle to the underlying physical-delivery to the same level as that of the underlying physical-delivery contract.

D. Adopt "single-month" and "all-months-combined" non-spot month position limits. The non-spot month position limits would be set as the sum of (i) 10% of the first 25,000 contracts; and (ii) 2.5% of open interest beyond 25,000 contracts. Under this approach, the Commission would eliminate the calendar-spread exemption within single-month limits (the Commission views such exemption unnecessary because it will set single-month limits at the same levels as all-months-combined limits). The minimum levels, however, would be set at the greater of the above calculation and 1,000 for referenced contracts in an agricultural commodity or 5,000 for referenced contracts in an exempt commodity. Physically-settled and cash-settled contracts would be netted for purposes of the single-month and all-months-combined limits.

E. Adopt a new, more restrictive, definition of *bona fide* hedging position for referenced contracts that requires the hedging transaction to represent cash market transactions and offset cash market risks (the "incidental test"), rather than transactions that would normally, but not necessarily, represent a substitute for cash market transactions or positions. All exemptions provided under the *bona fide* hedging exemption must satisfy two requirements: (1) the incidental test and (2) the "orderly trading requirement" (which imposes on hedgers the duty to establish and liquidate positions "carefully in the ordinary course of business").

In addition to the two requirements that must be satisfied for every *bona fide* hedging position, the exemption for excluded commodities requires that the "economically appropriate test" be satisfied. Such test requires that the position be economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise. The Commission has proposed guidance listing risk management positions that would qualify.

The *bona fide* hedging position definition also includes a new exemption for "pass-through swaps," *i.e.*, swaps entered into by a dealer with counterparties who may rely on the *bona fide* hedging exemption.

The exemption for physical commodities applies to futures, options, swaps and linked foreign futures contracts listed on a foreign board of trade that are economically equivalent to exchange-listed contracts. In addition to fulfilling the incidental test, orderly trading requirement and the economically appropriate test, a trader relying on this exemption must satisfy the "change in value requirement" (*i.e.*, the position arises from the potential change in value of assets, liabilities or services) and the "temporary substitute test" (*i.e.*, the position is a substitute for a position to be taken on in the future in the physical marketing channel).

The *bona fide* hedging definition lists other enumerated exemptions, including a cross-commodity hedge, among several others. The unfilled storage capacity hedge exemption is not included, however.

F. Establish reporting requirements by substantially revising Part 19. Such revisions will extend reporting requirements to any person claiming an exemption from federal position limits, add new Forms 504, 604 and 704 to facilitate such reporting, and update the type of data to be reported and the time allotted to submit such reports.

G. Provide an exception for pre-existing positions. In the spot-month, only certain swaps (depending on the time at which they were entered into) are exempted. For non-spot months, pre-existing positions in commodity derivative contracts acquired before the effective date of the position limits rules are exempted. However, certain swaps will not be exempted if a trader has increased its position after the effective date of the position limits rules.

H. Provide that the aggregate position limits would apply to a trader's positions in referenced contracts that settle to a referenced contract that are executed on or subject to the rules of a foreign board of trade that allows direct access to its trading system for participants located in the U.S.

III. COMMENTS TO THE POSITION LIMITS PROPOSAL

A. Section 4a of the Commodity Exchange Act Mandates that the Commission Make Specific Findings Before it May Impose Position Limits

1. The Commission has not fulfilled its statutory obligation to make a necessity finding before imposing position limits.

Section 4a(a)(1) of the Commodity Exchange Act (the "**Act**"), as amended, sets forth the Commission's broad authority to set such position limits as the Commission finds are necessary to diminish, eliminate, or prevent such burden to interstate commerce caused by excessive speculation that causes sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity. Section 737 of the Dodd-Frank Act[11] added Sections 4a(a)(2) through (7) to the Act. Section 4a(a)(2) authorizes the Commission, in accordance with the standards set forth in Section 4a(a)(1) described above, with respect to physical commodities (agricultural, metals,

[11] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376 (2010).

and energy, but not excluded commodities such as interest rates, currencies, or stock indices) to establish limits on the amount of positions, as appropriate, other than *bona fide* hedge positions. The legislative history of the Dodd-Frank Act indicates that the Commission's setting of position limits is intended to be an authorized, rather than a required, action.[12] Section 4a(a)(3) of the Act specifies that if the Commission establishes the limits in Section 4a(a)(2), it must set limits on the number of positions that may be held by any person for the spot month, each other month, and the aggregate number of positions that may be held by any person for all months, to the maximum extent practicable, in its discretion, to achieve the following four statutory goals: (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.[13]

In the NPRM, the Commission argues that "it is reasonable to construe [section 4a(a) of the Act] to mandate that the Commission impose position limits."[14] In doing so, it appears that the Commission misinterprets the statute and the holding of the D.C. District Court in *ISDA v. CFTC*. The court in *ISDA* stated that there were at least two plausible readings of the statute: the CFTC's reading and the plaintiffs' interpretation, but went on to say that the CFTC's interpretation "renders other parts of Section [4a] mere surplusage."[15] The court continued, "Significantly, [the CFTC's interpretation] fails to give any meaningful effect to the very first clause of Section [4a(a)(2)], which requires that the CFTC establish position limits '[i]n accordance with the standards set forth' in subsection (a)(1)."[16]

The D.C. District Court found that section 4a(a)(1) "clearly and unambiguously requires the Commission to make a finding of necessity prior to imposing position limits."[17] Throughout its opinion, the court found that there is a clear statutory requirement that the Commission make

[12] See S. Rept. 111-176 (Apr. 30, 2010), "This section <u>authorizes</u> the CFTC to establish aggregate position limits across commodity contracts listed by designated contract markets, commodity contracts traded on a foreign board of trade that provides participants located in the United States with direct access to its electronic trading and order matching system, and swap contracts that perform or affect a significant price discovery function with respect to regulated markets." (emphasis added).

[13] Section 4a(a)(5) of the Act requires the Commission to establish limits on the amount of positions, as appropriate, other than *bona fide* hedge positions, that may be held by any person with respect to swaps that are economically equivalent to futures or options contracts traded on a DCM. In establishing these limits, the Commission must address similar requirements as those described in Section 4a(a)(3) described above.

[14] Position Limits for Derivatives, 78 Fed. Reg. at 75,681.

[15] *International Swaps and Derivatives Association v. U.S. Commodity Futures Trading Commission*, 887 F.Supp.2d 259, 279 (D.D.C. 2012).

[16] *ISDA*, 887 F.Supp.2d at 279-80.

[17] *Id*. at 269 ("The precise question, therefore, is whether the language of Section [4a(a)(1)] clearly and unambiguously requires the Commission to make a finding of necessity prior to imposing position limits. The answer is yes.").

a necessity finding before imposing position limits.[18] However, the Commission continues to construe section 4a(a)(1) of the Act as a Congressional mandate requiring the Commission to establish position limits.[19] The Commission states: "The Commission also concludes that the mandate requires it to impose such limits without first finding that any such limit is necessary to prevent excessive speculation in a particular market."[20] However, "out of an abundance of caution," the Commission makes a preliminary finding that position limits are necessary as a prophylactic measure, and cites to two examples that purportedly support its contention.[21] The Commission cites to the Hunt Brothers scenario in the silver futures market of the late 1970s and the events in the natural gas futures market during the mid-2000s where Amaranth Advisors, LLC held derivatives that equated to up to 5 percent of the natural gas used in the U.S. in a year, but did not own or control any physical natural gas.[22]

In describing these two scenarios, the Commission itself recognizes the ability of exchanges to react to price turbulence, and specifically cites to the Chicago Board of Trade and Commodity Exchange, Inc.'s responses to the Hunt Brothers scenario, whereby both exchanges implemented emergency rules that imposed position limits, increased margin requirements and limited trading to liquidation purposes only.[23] Yet, using these two cases, the Commission seeks to justify the broad imposition of federal speculative position limits on the market as a whole – specifically, on 28 core referenced futures contracts and related "referenced contracts," including options and swaps contracts. MFA is concerned that the Commission's "necessity" finding is described in a vacuum – the Commission discusses only two scenarios, related to only two commodities, and does not reference the impact of new developments in the marketplace and new tools available to the Commission.

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[18] *Id*. at 270 ("The text does not state (nor has it ever) that the CFTC may do away with or ignore the necessity requirement in its discretion. There is no ambiguity as to whether the statute requires the CFTC to make such findings, and the CFTC has never apparently treated the statute as ambiguous on this point. Accordingly, the Court concludes that § [4a(a)(1)] unambiguously requires that, prior to imposing position limits, the Commission find that position limits are necessary to 'diminish, eliminate, or prevent' the burden described in Section [4a(a)(1)].'"); 271 ("Section [4a(a)(1) contains a clear statutory requirement that the CFTC find that any position limits 'are necessary to diminish, eliminate, or prevent' the burden on interstate commerce described in the statute."); 272 ("As set forth above, the language of Section [4a(a)(1)] is clear and unambiguous regarding the Commission's duty to make a necessity finding."); and 273 ("As Plaintiffs correctly note, '[w]hat the plain language of Section [4a(a)(1)] does not permit is the establishment of position limits – whether prophylactic or remedial – without any necessity finding at all." (internal citations omitted)).

[19] Position Limits for Derivatives, 78 Fed. Reg. at 75,681.

[20] *Id*. at 75,681-82 (emphasis added).

[21] *Id*. at 75,685.

[22] Position Limits for Derivatives, 78 Fed. Reg. at 75,691.

[23] Position Limits for Derivatives, 78 Fed. Reg. at 75,685-86.

2. The Commission's proposed limits do not strike the right balance among the prescribed statutory goals of diminishing excessive speculation and deterring market manipulation, and ensuring sufficient market liquidity for bona fide hedgers and the price discovery function of the underlying market.

Although the Dodd-Frank Act provides the Commission with discretion and does not specify what weight the Commission must give to each of the four goals enumerated in Section 4a(a)(3) of the Act,[24] the Dodd-Frank Act requires the Commission to maximize to the extent practicable each of these four goals when setting limits. Congress requires balance in establishing limits, and in seeking to further one objective (e.g., preventing excessive speculation), the Commission needs to do so in a manner that does not adversely affect another objective (e.g., ensuring liquidity). MFA believes that the Commission has not struck the appropriate balance among these four goals, but instead has focused on addressing the fear of excessive speculation and market manipulation at the expense of ensuring sufficient market liquidity and price discovery. Further, MFA believes that the Commission has not adequately considered, as required under Section 4a(a)(2)(C) of the Act, whether the NPRM will cause price discovery in the referenced commodities to shift to trading on foreign boards of trade.[25] The referenced contracts are global commodities that are traded worldwide; therefore, the Commission should not implement rulemaking until there is global cooperation on position limits, otherwise U.S. markets will be disadvantaged.

3. Speculation Actually Benefits the Marketplace

Extensive studies have been undertaken by public and private institutions around the world on speculative position limits; in fact, the Commission cites to many of the same studies MFA has reviewed.[26] However, in discussing only the Hunt Brothers and Amaranth case studies

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[24] Section 4a(a)(3) of the Act specifies that if the Commission sets federal position limits, it must strive to achieve the following four statutory goals: (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. 7 U.S.C. § 6a(a)(3).

[25] Section 4a(a)(2)(C) states, "In establishing the limits required under subparagraph (A), the Commission shall strive to ensure that trading on foreign boards of trade in the same commodity will be subject to comparable limits and that any limits to be imposed by the Commission will not cause price discovery in the commodity to shift to trading on the foreign boards of trade." The Commission does not provide an analysis of whether price discovery will shift to a foreign board of trade. *See* Position Limits for Derivatives, 78 Fed. Reg. at 75,766.

[26] Position Limits for Derivatives, Appendix A, 78 Fed. Reg. at 75,784. Many of these reports relate to the energy price volatility of 2007-2008, and seek to identify and explain the underlying factors. MFA has found that reputable research and commentary from a range of sources have concluded that fundamental factors of supply and demand, along with economic factors such as the decline in the U.S. dollar, were primarily responsible for price volatility. *See, e.g.*, GAO Briefings to the House Committee on Agriculture on Issues Involving the Use of Futures Markets to Invest in Commodity Indexes (Dec. 2008), International Organization of Securities Commission's Technical Committee (IOSCO) Final Report (Mar. 2009), IMF World Economic Outlook (Oct. 2008), HM Treasury Global Commodities: A long term vision for stable, secure and sustainable global markets (June 2008), CME Group white

the Commission has not given adequate weight to the benefits that speculators provide to the market. Speculators such as funds absorb risk from hedgers and provide liquidity to both sides of the market.[27] Producers and users rarely meet directly, given the different sizes, durations, and specifications of their needs, and instead rely on speculators to take the opposite position. In a study by the OECD, research found that there was a negative correlation between speculative positions and market volatility, concluding that "there is some consistent evidence that increases in trader positions are followed by lower market volatility."[28] This follows on studies by Haigh, Hranaiova and Overdahl, which found that "hedge funds [do] not affect price levels in energy futures markets, yet[…] are very important to the functioning of the market through the liquidity they provide to other participants," and by Commission staff, which observed that "hedge fund

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paper "Excessive Speculation and Position Limits in Energy Derivatives Markets," available at http://cmegroup.com/company/files/PositionLimitsWhitePaper.pdf, *Dr Evil, or drivel? The charge-sheet against commodity speculators is flimsy*, Economist, Nov. 11, 2010 ("In fact there is little empirical evidence that investors cause more than fleeting distortions to commodity prices. The most persuasive explanation for the rises and falls of commodities is demand and supply."), Irwin, Scott. H., and Sanders, Dwight R., 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); and Lawrence Eagles, J.P. Morgan, "With Better Data, Better Understanding" (Jan. 27, 2009).

To illustrate this conclusion, between December 31, 2007 and June 30, 2008, when the NYMEX Crude Oil price rose from $96 to $140 per barrel, open interest rose from 2.5 million to 2.8 million contracts, but the commodity index investment (i.e., speculative investment) fell from 408,000 to 363,000 open long contracts. Commission staff summarized this result stating:

> While the net notional value of commodity index business in NYMEX WTI crude oil increased sharply over the 6-month period ending on June 30, 2008—by about 30 percent, the actual numbers of equivalent long futures contracts declined over that same period by about 11 percent. In other words, the sharp rise in the net notional value of commodity index business in crude oil futures appears to be due to an appreciation of the value of existing investments caused by the rise in crude oil prices and not the result of more money flowing into commodity index trading.

CFTC Staff Report on Commodity Swap Dealers & Index Traders (Sept. 2008). There was no evidence to indicate that excessive speculation was to blame, as speculators were actually reducing their long positions during this period. *See, e.g.*, "Commodity Price and Futures Positions" (Dec. 16, 2009), Ruy Ribero, Lawrence Eagles and Nicholas von Solodkoff, J.P. Morgan; "We can safely say there is no indication in this data of the fact speculators are pushing the price of oil," Christophe Barret, global oil analyst at Credit Agricole, quoted in Energy Risk (Apr. 13, 2010), available at http://www.risk.net/energy-risk/news/1600919/cftc-speculators-influence-commodity-markets; Prepared Testimony of Philip K. Verleger, Jr., Haskayne School of Management, University of Calgary, PKVerleger LLC, to Commodity Futures Trading Commission on The Role of Speculators in Setting the Price of Oil (Aug. 5, 2009); "Speculators Cleared in U.K. Oil Volatility" (July 28, 2009), *The Wall Street Journal*; and CFTC Interagency Task Force on Commodity Markets, Interim Report on Crude Oil.

[27] "The short hedgers and long investors provide liquidity for each other by using futures markets to serve their respective interests in an open, transparent and efficient manner. Liquidity will be essential to make sure each can achieve their objectives at an efficient price. Artificial limits on that liquidity should not be imposed. There are numerous ways to further the objectives of enhanced transparency and reduced systemic risk that do not involve reductions in much needed liquidity." Prepared Statement Before the Commodity Futures Trading Commission of Kevin Norrish, Managing Director of Commodities Research, Barclays Capital (Mar. 25, 2010).

[28] Irwin, S. H. and 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), digital object identifier: 10.1787/5kmd40wl1t5f-en.

trading activity is beneficial in that it contributes to bringing in line the prices of commodity futures at different maturities."[29] The availability of speculators to take long and short positions, bring in new information, and express countervailing views, helps complete the market for hedgers, smooth out volatility, and aid in price discovery. While the term "speculator" is an age-old technical designation, it has unfortunately taken on a pejorative connotation in recent years, which detracts from this important role.

Position limits, even purportedly generous ones, may impair the ability of markets to serve their essential risk shifting function, which would increase the cost of managing risk and harm hedgers, and ultimately consumers of these products. Studies have demonstrated that on prior occasions where trading by investors was restricted, such as by prohibiting futures transactions in certain commodities (Chicago onions, Berlin wheat), the result was significantly greater, and not less, price volatility.[30] Studies comparing price volatility in various commodities (wheat, cotton, oats, sugar, butter, eggs, rubber, silk, copper, silver, lead, zinc, soybeans, linseed, and hogs) before and after the establishment of futures markets for such commodities also demonstrate that futures markets are associated with lower price volatility.[31] Longstanding research, including studies conducted by the Commission, has shown that speculators and index funds perform an essential function in the commodity markets by transferring risk from commercial participants, providing liquidity, reducing volatility, and contributing to the price discovery process, which benefits hedgers and all consumers and producers of the commodities.[32]

MFA contends that the best available evidence discounts the theory that there is excessive speculation distorting the prices in the commodity markets. Accordingly, we believe that it would be inappropriate to adopt the NPRM given the weight of the evidence and that the position limits proposed in the NPRM will place a greater burden on interstate commerce by hindering the ability of derivatives markets to (i) ensure that the price discovery function of the

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[29] See Büyükşahin, Haigh, Harris, Overdahl and Robe, Fundamentals, Trader Activity and Derivative Pricing (Dec. 4, 2008), *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/marketreportenergyfutures.pdf.

[30] "At a minimum, there is no evidence for the claim that futures markets are associated with higher price volatility. Indeed, the results presented in this paper strongly suggest the opposite: futures markets were associated with, and most likely caused lower commodity price volatility." "Populists versus theorists: Futures markets and the volatility of prices" (June 2006), Explorations in Economic History 44 (2007) 342-362, at 357, David S. Jacks ("Jacks Study"), available at www.sciencedirect.com.

[31] Jacks Study, at 352.

[32] *See, e.g.*, "A Review of Recent Hedge Fund Participation in NYMEX Natural Gas and Crude Oil Futures Markets," New York Mercantile Exchange, Mar. 1, 2005; "Price Dynamics, Price Discovery and Large Futures Trader Interactions in the Energy Complex, Working Paper First Draft: Apr. 28, 2005," Michael S. Haigh, Jana Hranaiova, and James A. Overdahl, Office of the Chief Economist, U.S. Commodity Futures Trading Commission ("Commission Energy Complex Report"); Testimony of Craig Pirrong, Professor of Finance, Director, Global Energy Management Institute, Bauer College of Business, The University of Houston, Before the House Committee on Agriculture (July 7, 2008) ("Pirrong Testimony"); Jacks Study at 342-362.

underlying market is not disrupted; and (ii) perform their fundamental risk transfer and risk management functions, both of which depend on the existence of liquid, fair and competitive markets to ensure sufficient market liquidity for *bona fide* hedgers.[33]

4. The Commission's proposed limits are a flawed cure for a problem that the Commission has not found to exist.

MFA believes that the prophylactic steps the Commission proposes are flawed and are potentially harmful to the health of the market. Although position limits may reduce the ability of persons with market power to squeeze or corner the market, they have been described as a crude and inefficient tool.[34] This is because it is difficult to set the limits at a level that inhibits market manipulation without unduly affecting the ability of markets to efficiently transfer risk. We recommend alternatives to using such a blunt instrument.

MFA believes that the proposed position limits will potentially reduce liquidity in U.S. derivatives markets. Aside from the overall imposition of position limits, there are several other aspects of the NPRM that we believe will significantly impact liquidity in the derivatives markets. Additionally, MFA questions whether the Commission's approach will promote the goal of preserving market integrity. If the imposition of position limits on U.S. futures exchanges and swap execution facilities drives more trading offshore, the Commission will have more difficulty conducting effective market surveillance and preventing potential price manipulation in the underlying commodities.

Better alternatives than position limits are presently available to the Commission to deter market manipulation. Through the use of the current position reporting and market surveillance regime, and the ability to impose penalties for disruptive market behavior, the Commission and exchange surveillance staff can detect and prevent corners, squeezes, and other forms of manipulation. It is preferable, therefore, to use readily available market data and the Commission's statutory authority to investigate and prosecute aggressive traders that manipulate or attempt to manipulate the market, than to limit the trading activity of all other market participants through position limits. An effective enforcement regime will discourage manipulation and assure a proper balance – preventing excessive speculation and deterring market manipulation, while ensuring sufficient market liquidity and price discovery.[35]

MFA believes that, when the Commission exercises its regulatory oversight authority, it must be cognizant of the effect of the proposed federal limits on the ability of futures markets to

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[33] *See, e.g.*, Pirrong Testimony, at 3.

[34] Pirrong Testimony, at 5.

[35] The Commission recognizes that there is academic support for this notion, and cites to a study by Craig Pirrong ("Squeezes, Corpses, and the Anti-Manipulation Provisions of the Commodity Exchange Act," Oct. 1, 1994). Position Limits for Derivatives, 78 Fed. Reg. at 75,695.

perform their fundamental price discovery, risk transfer, and risk management functions, which depend on the existence of liquid, fair, and competitive markets. Therefore, any proposal that would tend to adversely affect the liquidity, fairness or competitiveness of the futures markets must be carefully scrutinized. MFA disagrees with the Commission's finding that position limits are necessary or appropriate, and does not believe that position limits are an effective tool to address excessive speculation. Nevertheless, if the Commission determines that position limits are necessary, MFA provides the suggestions below intended to assist the Commission with its policy objectives without compromising the integrity of the market and in a manner that is less disruptive to the liquidity of the market and to the operations of market participants.

B. The Commission Should Provide Clear Guidance on Referenced Contracts and the Economic Equivalence Determination

MFA recommends that the Commission issue clearer guidance as to how it determines when a contract is a "referenced contract." Clarity is needed to help prevent inadvertent violations of position limits that could occur when a person makes its own determination, as it must, as to whether a contract is a referenced contract. The Commission proposes to impose position limits on referenced contracts, which include, generally, futures, options and swaps contracts that are directly or indirectly linked to the price of a particular core referenced futures contract or the price of the same commodity underlying the particular core referenced futures contract for delivery at the same location or locations as specified in the particular core referenced futures contract.[36] Swaps that are "economically equivalent" to futures and options contracts fall within the position limits regime, but the meaning of "economically equivalent" is unclear because neither the statute nor the Commission defines this term.[37] Rather, the Commission interprets this term to require that a swap satisfy the definition of "referenced contract" to determine whether the swap is within the position limits regime, noting that any other similarities or differences that exist between futures and swaps *are not material* to making this determination.[38] The Commission should provide clearer guidance on its interpretation of economical equivalence so market participants can more effectively determine whether a swap is within the position limits regime.

While the Commission has explicitly listed the core referenced futures contracts in a table in proposed rule 150.2(d), it has not provided the same certainty with respect to referenced contracts in the proposed rules. Instead, the Commission has posted to its website a list of 464 contracts with Commission staff's views on whether specific contracts would be deemed to be

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[36] Proposed rule 150.2(d) at 75,826 (imposing speculative position limits on referenced contracts); proposed rule 150.1 at 75,825 (defining referenced contracts).

[37] Position Limits for Derivatives, 78 Fed. Reg. at n. 378, 75,723.

[38] *Id*. (emphasis added).

"in" or "out" of the position limits regime.[39] The list is helpful as far as it goes. However, the Commission's list appears to address only exchange-listed contracts. We believe the Commission should provide examples of OTC contracts, and contracts traded on a foreign board of trade, to the extent there are economically equivalent contracts.

Moreover, the Commission did not describe the methodology it used in compiling this list of referenced contracts or provide related guidance. Nor is there any discussion of whether and how this list will be updated or maintained. As a result, market participants will not be able to compute their positions with regulatory certainty, but will be required to exercise their judgment and make good faith determinations to resolve whether a contract that is not on the list, especially a customized swaps contract, is a referenced contract.

MFA believes that the Commission should describe the approach it intends to take with respect to customized contracts. MFA recommends that the Commission make clear that it will not take enforcement action against a person that can demonstrate that it had a reasonable basis for determining that a particular contract was not a referenced contract. In the absence of specific Commission guidance, the Commission should not use a strict liability standard to find violations of position limits by a person that has reasonably calculated its positions in good faith. Further, MFA recommends that the Commission make the list of referenced contracts formal guidance, and publicly announce and publish for comment each time the Commission wishes to add contracts to or remove contracts from the list. In relation to such additions or removals, the Commission should establish an implementation and transition period to allow market participants to incorporate the change in contract status into their calculations.

C. The Commission Should Address the Computational Challenges for Options

MFA supports the Commission's proposal that does not mandate a specific option valuation model to be used by persons in calculating the futures equivalent[40] value of an option for purposes of calculating position limits. However, the absence of a standardized model may

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[39] CFTC Staff Workbook of Commodity Derivative Contracts Under the Proposed Regulations Regarding Positions Limits for Derivatives, *available at* http://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/PositionLimitsforDerivatives/ssLINK/poslimitsworkbook.

[40] The NPRM defines "futures equivalent" to mean:

> (1) An option contract, whether an option on a future or an option that is a swap, which has been adjusted by an economically reasonable and analytically supported risk factor, or delta coefficient, for that option computed as of the previous day's close or the current day's close or contemporaneously during the trading day, and;
>
> (2) A swap which has been converted to an economically equivalent amount of an open position in a core referenced futures contract.

Proposed rule 150.1, 78 Fed. Reg. at 75,825.

give rise to regulatory uncertainty, which the Commission should seek to alleviate. MFA recommends that the Commission provide guidance on whether the Commission will deem an option valuation model to be unsatisfactory and, if so, the factors the Commission would consider in arriving at such an opinion. MFA also recommends that the Commission adhere to a reasonableness approach by explicitly providing that (1) a model that produces results within 10 percent of an exchange or Commission model is presumed to be a reasonable model unless the Commission can demonstrate otherwise, and (2) a person whose model deviates by more than 10 percent from an exchange or Commission model may use such model if it can demonstrate that its model is reasonable under prevailing market conditions.

Market participants use different option valuation models, often proprietary, to convert options into futures equivalents, and should be permitted to rely on the outputs of these models when calculating position limits. The Commission has not, and MFA agrees that it should not, prescribe a specific option valuation model that all persons must use to calculate position limits. However, the Commission should provide guidance on the factors it will use to determine whether a model is "economically reasonable and analytically supported."[41] MFA believes that the Commission should not second guess the results of reasonable models and impose findings of violations after-the-fact. To do so would introduce tremendous uncertainty into compliance with the position limits regime. Therefore, MFA recommends that the Commission adhere to the approach described above, which would explicitly provide that (1) the use of a model that produces results within 10 percent of an exchange or Commission model is presumed to be a reasonable model unless the Commission can demonstrate otherwise, and (2) a person whose model deviates by more than 10 percent from an exchange or Commission model may use such model if it can demonstrate that its model is reasonable under prevailing market conditions.

MFA further recommends that the Commission consider the exchanges' approach to option valuation where appropriate because these approaches are already in use and familiar to market participants. For example, CME Rule 562 provides that, "if, at the close of trading, a position that includes options exceeds position limits when evaluated using the delta factors as of that day's close of trading, but does not exceed the limits when evaluated using the previous day's delta factors, then the position shall not constitute a position limit violation."[42] MFA encourages the Commission to adopt a similar provision in its position limits rules.

D. Position Limits Should Be Based on Current Estimated Deliverable Supply Data and Transparency

MFA recommends that the Commission use current data to calculate estimated deliverable supply. Estimated deliverable supply, which is used for setting both exchange and CFTC spot-month limits, must have a reasonable correlation to actual deliverable supplies. We

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[41] *See, e.g.*, proposed rule 150.1, 78 Fed. Reg. at 75,825.

[42] CME Rulebook, Rule 562, *available at* http://www.cmegroup.com/rulebook/CME/I/5/5.pdf.

understand from the analysis conducted by the CME Group, Inc. that the Commission has not approved new estimates of deliverable supply for many commodity contracts covered by the NPRM—in some cases for over decades. For example, estimated deliverable supply for natural gas has not been updated since 1996 and gold and silver have not been updated since 1983. Using outdated information to establish position limits has the practical effect of creating position limits that are too low and not reflective of current market conditions. CME Group, Inc. has provided the Commission with updated deliverable supply estimates, which should result in higher spot-month limits based upon the Commission's proposed spot-month position limits calculation that is 25% of deliverable supply. However, the Commission has proposed that it base position limits on CME's more recent data only as an alternative approach.[43] MFA supports the Commission's alternative approach that would use more recent estimated deliverable supply data to establish position limits for the spot month.

MFA has concerns with respect to the Commission's proposed "deliverable supply" definition, similar to those raised in previous proposals.[44] In response to previous comments requesting greater certainty on deliverable supply, the Commission modified the Vacated Rules in just one respect, explicitly permitting DCMs to use Commission guidance for purposes of calculating deliverable supply.[45] However, the guidance to which the Commission refers, Appendix C to Part 38, is broad, vague and subject to different interpretations amongst the DCMs and other market participants. For example, the Commission has not provided clear guidance on the inclusion of remotely located commodities in the deliverable supply computation, or whether certain conditions must first exist before the inclusion of such commodities is appropriate. As such, it is difficult to determine whether the Commission's proposal to base position limits on estimated deliverable supply will result in too narrow or too broad a calculation.

MFA respectfully recommends that the Commission use this opportunity to address the concerns of industry stakeholders, and provide greater clarity on deliverable supply. For example, MFA welcomes guidance on barge traffic and specifically requests that the Commission confirm that commodities transported to the delivery point and priced within a specified percentage of the prevailing spot price for the relevant commodity at the delivery point are appropriately included in a DCM's estimated deliverable supply calculation. In doing so, the Commission will provide a more objective and transparent method of determining whether barge traffic carrying a commodity would fall within estimated deliverable supply.

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[43] Position Limits for Derivatives, 78 Fed. Reg. at 75,727.

[44] Previous commenters on the Vacated Rules expressed concerns with the Commission's unclear definition of deliverable supply. These commenters included the International Swaps and Derivatives Association, Securities Industry and Financial Markets Association, Alternative Investment Management Association, National Grain and Feed Association and CME Group, Inc., among others. *See* Position Limits for Futures and Swaps, 76 Fed. Reg. at 71,633.

[45] *Id*. at 71,634.

E. The Commission Should Not Impose Position Limits for Cash-Settled Contracts and, in the alternative, Position Limits for Cash-Settled Contracts Should Not Be Based on Estimated Deliverable Supply

In previous comment letters, MFA urged the Commission to reconsider the imposition of position limits based on estimated deliverable supply on cash-settled contracts, and continues to recommend that the Commission do so.[46] Although deliverable supply is an appropriate basis for setting limits on physically-settled contracts because those contracts involve the making and taking of delivery and have an impact on a commodity's settlement price, the same is not true of cash-settled contracts. As we have previously contended, there is no economic relationship or rationale for linking position limits on cash-settled contracts to deliverable supply, and the imposition of equal position limits for cash-settled and physically-delivered contracts is based on the incorrect assumption that cash-settled and physically-delivered contracts are fungible. As a result, the position limits for cash-settled contracts may unnecessarily constrain legitimate risk management activity with the cash-settled contract in the spot month. Accordingly, MFA recommends that the Commission adopt final rules that do not impose position limits on cash-settled contracts.

In the event that the Commission decides to impose position limits on cash-settled contracts, MFA urges the Commission to reconsider using estimated deliverable supply to calculate such position limits. Estimated deliverable supply is tied to a given delivery point and, as such, is a misguided approach for cash-settled contracts – certain benchmark contracts, such as the NYMEX Henry Hub Natural Gas contract, are widely used by a range of commercial hedgers to manage their risks. In many instances, the hedger has no intention of making or taking delivery at the Henry Hub, but rather uses the cash-settled contract for its superior liquidity and price discovery to hedge risks in other locations or for other commodities with significant natural gas inputs. By limiting the calculation of deliverable supply only to this one point in Erath, Louisiana, however, the Commission would be ignoring the sizable hedging activity in cash-settled contracts and arrive at a number far too low to accommodate this type of activity. The Commission's one-size-fits-all approach does not give due consideration to market dynamics.

F. The Commission Should Adopt the Second Alternative to the Conditional Spot-Month Position Limit Exemption

MFA has specific concerns about the Commission's proposed rule 150.3(c), which would prohibit traders from acquiring positions in the spot-month physical-delivery referenced contract. Under the Commission's proposal, a trader could acquire positions up to five times the spot-month limit in cash-settled contracts as long as the trader does not hold or control any positions in the spot-month physical-delivery referenced contract. In response to concerns regarding the

[46] MFA 2010 Comment Letter at 15-16; MFA 2011 Comment Letter at 16-17.

proposed conditional spot-month position limit exemption's impact on the price discovery function of the physical-delivery market and liquidity for *bona fide* hedgers in the physical-delivery contracts, the Commission has proposed three alternatives to the proposed conditional spot-month position limit exemption. The first alternative restricts the exemption to positions in cash-settled contracts that settle to an index based on cash-market transactions prices. The second alternative sets the limit for cash-settled contracts at five times the level of the limit for the physical-delivery core referenced futures contract regardless of positions in the underlying physical-delivery contract. The third alternative limits cash-settled contracts that settle to the underlying physical-delivery to the same level as that of the underlying physical-delivery contract. MFA supports the Commission's second alternative to the proposed conditional spot-month limit exemption.

MFA supports this alternative because of the concern that proposed rule 150.3(c) would unnecessarily constrain funds in their day-to-day trading. For example, for a fund with multiple trading strategies, some of which use physically-delivered contracts and others use cash-settled contracts in the same commodity, the proposed rule's prohibition on holding any positions in the physical-delivery contract would severely constrain the fund's trading strategies. Thus, this type of fund would be blocked from one market altogether and unnecessarily constrained. Another concern is that proposed rule 150.3(c) may incentivize some traders to trade only in the cash-settled contract, adversely affecting price discovery and liquidity in the physical-delivery contract. The Commission should strive to promote price discovery and market participation. Proposed rule 150.3(c) has the opposite effect. The second alternative would allow traders to implement multiple trading strategies without blocking them from certain markets or unnecessarily constraining their trading strategies. Therefore, MFA recommends that the Commission adopt the second alternative to the conditional spot-month position limit exemption.

G. The One-Size-Fits-All Approach to Setting Non-Spot Month and All-Months-Combined Limits Fails to Incorporate Market Realities Unique to Specific Commodities

MFA has several concerns regarding the non-spot month limit proposals, and seriously questions the necessity of an all-months-combined limit when settlement occurs at a future point in time and contracts are subject to spot month limits at such time. The Commission's application of the same percentage of open interest to non-spot month and all-months-combined position limits and the calculation of these position limits based on incomplete data are issues that should be addressed to facilitate the operation of the position limits regime with as little disruption and uncertainty as possible.

MFA continues to be concerned that the Commission is choosing a uniform, one-size-fits-all approach to setting position limits. MFA has commented on this issue in the past,[47] and now respectfully requests the Commission to seriously consider the implementation of more

[47] MFA 2010 Comment Letter at 7; MFA 2011 Comment Letter at 10.

appropriate position limits for different commodities. For example, the Commission treats all commodities in the same manner by setting position limits at 10% of open interest on the first 25,000 contracts and 2.5% on contracts over 25,000.[48] We do not believe that this approach recognizes the differing characteristics among markets. Different commodities have unique characteristics based on seasonality, trends and fluctuations based on other events.

If position limits are based on an arbitrary and uniform percentage of open interest, such limits will not factor in seasonality or macro-economic trends, thereby causing position limits to lag behind market trends. Open interest can change dramatically from year to year depending on external events that impact prices, such as regime change in commodity-producing countries, significant changes in weather or economic events. Position limits should be a function of the liquidity of the market, which would prevent a cycle causing open interest to continually decrease year after year from occurring. If a slow year is followed by a more active year due to macro events, the position limits will limit liquidity when it is most needed. For example, open interest in NYMEX WTI reached record levels in 2011 due to the Arab Spring in countries such as Egypt and Libya.[49] More recently, exchanges with the flexibility to respond to market conditions have increased position limits on electricity contracts necessitated by the "polar vortex" weather conditions that most of the U.S. and Canada experienced in January 2014.[50] Limits that do not respond quickly to these types of global events, seasonal trends or other economic forces may limit liquidity. MFA recommends that the Commission adopt final rules that give the Commission the flexibility to increase position limits immediately or with little delay so that the market can accurately respond to external forces without violating position limits. Alternatively, the Commission should include peak open interest levels beyond the most recent two years when it determines the level of open interest on which to base position limits.

MFA notes that the Commission has not explained the reasons for applying the agricultural model to the energy and metals markets, especially in view of the different characteristics that distinguish these markets. For example, the energy and metals markets are more global, energy and metals commodities are more fungible, supplies of energy and metals commodities are much greater, and energy commodities production is subject to less seasonal variation than agricultural commodities. Moreover, the fact that contract sizes are not uniform across exchanges mandates that a different approach be taken, specific to the unique characteristics of various contracts. For example, a trader could hold one contract of a Henry Hub natural gas future (or 10,000 mmBtu)[51] and another trader could hold one contract of a

[48] Proposed rule 150.2(e)(4), Position Limits for Derivatives, 78 Fed. Reg. at 75,827.

[49] Press Release, CME Group, CME Group Announces Three Consecutive Open Interest Volume Records in Benchmark Light Sweet Crude Oil (WTI) Futures (Mar. 14, 2011).

[50] Gregory Meyer, *Big Bets on Power Cleared by Regulator*, FIN. TIMES (Jan. 21, 2014).

[51] CME Group Contract Specifications, *available at* http://www.cmegroup.com/trading/energy/natural-gas/natural-gas_contract_specifications.html.

PG&E Citygate Index future (or 2,500 mmBtu).[52] The former trader holds four times as much British thermal units of natural gas than the latter trader because the contract sizes are different. However, the Commission's one-size-fits-all approach to open interest does not take into account this type of discrepancy.

Although MFA has previously commented[53] on the built-in bias towards lower position limits within the recalculation of position limits, the Commission does not appear to have addressed our concerns. Under the proposed rules, the Commission will calculate open interest every two years, based on the higher 24-month average open interest.[54] However, MFA continues to have concerns that the recalculation will not factor fluctuations based on external factors or the built-in cushion traders implement to ensure that they stay under position limits, which is typically 10 percent or more. As a result, there will be lower open interest when position limits become effective and, because the recalculation looks back at prior open interest levels, the following year's position limits levels may be lower. The ultimate result is a self-reinforcing cycle of lower open interest and lower position limits in successive years.

Finally, we are concerned about the accuracy of the data available to the Commission used to measure open interest of OTC swaps in referenced commodities. The Commission explicitly acknowledges reporting errors: "Several reporting entities have submitted data that contained stark errors. For example, certain reporting entities submitted position sizes that the Commission determined to be 1000 times, or even 10,000 times, too large."[55] Commissioner O'Malia has publicly questioned the integrity of the OTC swap data that is reported to the Commission.[56] In addition, there are serious questions as to whether reporting parties are properly classifying the products for the data that they are reporting.[57] In response to these grave concerns, the Commission has instituted an interdivisional working group to review regulatory

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[52]ICE Futures U.S. Product Guide, *available at* https://www.theice.com/productguide/ProductSpec.shtml?specId=6590198.

[53] MFA 2010 Comment Letter at 16; MFA 2011 Comment Letter at 10.

[54] Position Limits for Futures and Swaps, 76 Fed. Reg. at 71,641-42 ("This procedure may provide for limits that would be generally less restrictive than the proposed limits, since, by way of example, a continued decline in open interest over two years under the Proposed Rule would result in a lower limit each year, whereas under the final rule the limit for the first year would not decline and the limit for the second year would be based on the higher 24-month average open interest."); Position Limits for Derivatives, 78 Fed. Reg. at 75,765.

[55] Position Limits for Derivatives, 78 Fed. Reg.at n.428, 75,734.

[56] Dissenting Statement of Commissioner Scott O'Malia, Position Limits for Derivatives, 78 Fed. Reg. at 75,841 ("It is especially troubling that the large trader data being reported under Part 20 of Commission regulations is still unreliable and unsuitable for setting position limit levels, almost two full years after entities began reporting data, and that we are forced to resort to using data from 2011 and 2012 as a poor and inexact substitute." (internal citation omitted).).

[57] Andrew Ackerman, *CFTC Misreporting Size of Swaps Market, Agency Says*, WALL ST. J., Dec. 18, 2013.

swaps data reporting.[58] MFA believes that the result of these data-related concerns, combined with the concerns outlined above, will be position limits that are too low to account for legitimate risk-reducing strategies or liquidity needs. Accordingly, the Commission should delay the position limits rules as they pertain to swaps until the interdivisional working group has received industry feedback on reporting issues and those issues have been resolved, thereby basing position limits for swaps on accurate data.

H. Quotes for Bilaterally-Negotiated OTC Swaps

MFA respectfully recommends that the Commission clarify its policies related to a bid or offer for a contract that, if accepted, would have the result of causing the party making such bid or offer to exceed position limits.[59] In the context of swaps in a referenced commodity, MFA believes that a mere indicative bid or offer or indication of interest for an OTC swap that does not result in a binding transaction should not result in a violation of position limits. MFA believes that the inclusion of indicative bids, offers, or indications of interest in the calculation of position limits could have a significant dampening effect on liquidity if it caused dealers to be unwilling to quote a market. Therefore, the Commission should explicitly provide that an indicative bid or offer for a swap in a referenced commodity will not result in a violation of position limits.

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We appreciate the opportunity to offer suggestions to the NPRM. We would be happy to discuss our comments or any other issues raised in the 2013 Position Limits Proposal at greater length with the Commission or its staff. If the staff has any questions, please do not hesitate to contact Jennifer Han or the undersigned at (202) 730-2600.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell
Executive Vice President & Managing Director,
General Counsel

Cc: The Hon. Mark Wetjen, Acting Chairman
The Hon. Scott O'Malia, Commissioner
The Hon. Bart Chilton, Commissioner

[58] CFTC Press Room, *CFTC to Form an Interdivisional Working Group to Review Regulatory Reporting* (Jan. 21, 2014), *available at* http://www.cftc.gov/PressRoom/PressReleases/pr6837-14.

[59] CME Rule 562, which applies to exchange traded futures contracts, provides that "any person making a bid or offer that would, if accepted, cause such person to exceed the applicable position limits shall be in violation of this rule."