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February 10, 2014

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

Re: Position Limits for Derivatives, RIN No. 3038-AD99

Dear Ms. Jurgens:

By a Notice of Proposed Rulemaking published in the Federal Register on December 12, 2013,[1] the Commodity Futures Trading Commission ("CFTC" or the "Commission") has proposed to institute a speculative position limits regime for certain "core referenced futures contracts" and futures, options, and swaps (including trade options) deemed to be economically equivalent to such contracts ("Position Limits NOPR"). The Position Limits NOPR largely follows the structure of the Commission's previous position limits rule[2] (the "Prior Rule") which was vacated by the US District Court.[3] The Position Limits NOPR proposes regulations to impose position limits on core referenced futures contracts and economically equivalent contracts pursuant to the Commodity Exchange Act ("CEA"),[4] as the same was amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank").[5]

The Position Limits NOPR (together with the associated proposed regulations on aggregation for position limits, herein referred to as the "Aggregation NOPR")[6] would institute a complex and burdensome regime to control "excessive speculation" in the affected commodity contracts.[7]

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[1] *Position Limits for Derivatives*, 78 Fed. Reg. 75680 (Dec. 12, 2013) ("Position Limits NOPR").

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

[3] *International Swaps and Derivatives Association* v. *United States Commodity Futures Trading Commission,* 887 F. Supp. 2d 259 (D.D.C. 2012).

[4] *See* 7. U.S.C. § 6a(a)(2), (5) (2013).

[5] Public Law No. 111-203, 124 Stat. 1376 (2010).

[6] *Aggregation of Positions*, 78 Fed. Reg. 221 (Nov. 15, 2013) (Notice of Proposed Rulemaking).

[7] While the Commission concludes in the Position Limits NOPR that Dodd-Frank "requires it to impose [aggregate position limits] without first finding that any such limit is necessary to prevent excessive speculation . . .", it goes on to explain that this conclusion flows from the Commission's belief

The regime the Commission proposes is in addition to position limits currently in effect for certain futures contracts, which are the "core referenced futures contracts" in the Position Limits NOPR, on designated contract markets ("DCMs"). Of the many elements of Dodd-Frank regulation adopted by the Commission, the position limits regime (including the proposals of the Aggregation NOPR) will likely prove to be the most difficult compliance challenge with the most burdensome requirements for end–users who use swaps and futures to hedge commercial risk, such as the members of the Coalition of Physical Energy Companies ("COPE").

The members of the Coalition of Physical Energy Companies ("COPE")[8] are physical energy companies in the business of producing, processing, and merchandizing energy commodities at retail and wholesale. COPE members generally use swaps, futures, options, and trade options in conjunction with their physical businesses, most typically for hedging. As COPE understands it, as physical commercial companies and hedgers in commodity markets, COPE members are among the intended beneficiaries of the proposed position limits regime. The CEA as amended by Dodd-Frank states that the goal of the Commission in setting position limits for derivatives is in part to diminish, eliminate, or prevent excessive speculation, and ensure sufficient market liquidity for *bona fide* hedgers.[9] While COPE's members do not perceive a material risk of unaddressed excessive speculation in the contracts they use for hedging, they do see a material risk of inadvertent violations of complex regulations, and anticipate the incurrence of increased expenses in implementing a compliance program arising from the Position Limits NOPR.

Overview

COPE members use futures, options, and swaps (including trade options) to hedge their commercial risk and otherwise operate their physical businesses. In doing so, they attempt to employ the most cost-effective techniques to optimize and risk-manage their businesses. As understood in a commercial sense, COPE members generally do not speculate in futures, options, and swaps.

It has been COPE's experience that DCMs and over-the-counter swap and physical markets have functioned efficiently and permitted commercial companies to make informed choices regarding the products they will use to manage risk in their commercial businesses and to purchase and sell physical commodity products (which now may be labeled commodity options/trade options). If a market participant is trading on a DCM and requires a hedge exemption, it can work with exchange compliance and, if warranted by its commercial operations, receive a hedge exemption establishing proper limits on its positions.

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that "Congress made the decision to impose limits" to combat excessive speculation that accounted for significant volatility and price increases in physical commodity markets, "and it is for the Commission to carry that decision out." Position Limits NOPR at 75682.

[8] The members are: Apache Corporation; EP Energy LLC; Enterprise Products Partners, L.P.; Iberdrola Renewables, Inc.; Kinder Morgan; MarkWest Energy Partners, L.P.; Noble Energy, Inc.; NRG Energy, Inc.; Shell Energy North America (US), L.P.; SouthStar Energy Services LLC; and Targa Resources.

[9] *See* 7 U.S.C. § 6a(a)(3)(B).

Through the proposals set forth in the Position Limits NOPR, the Commission would materially disrupt this efficient and commercially reasonable market and potentially distort efficient decision making. If the position limits regulations are finalized as proposed, commercial companies will have to reorient the concept of hedging from one of business-oriented commercial hedging to the new and highly stylized regulatory concept of enumerated *bona fide* hedging as created by the Commission (solely for compliance with the rule). They will also have to label and track all referenced contracts[10] entered into by them (and entities with whom they are aggregated) on a real-time basis (requiring, for example, immediate investigation into a transaction to determine if it somehow contains the indirect usage of a delivery location used in a core referenced futures contract). In addition, they will have to: calculate and include in such tracking the futures equivalent amounts of over-the-counter swaps and physical contracts; prepare and keep current the backup data as required by the Commission to support the filing of forms when position limits are exceeded or a conditional spot-month limit exemption is claimed; and create internal processes, procedures, and information technology solutions to ensure compliance.

While COPE members understand that the Position Limits NOPR is in large part intended to protect them from inappropriate market disruptions, the proposed construct creates a set of confusing burdens on end-user hedgers to solve a problem that the Commission itself is not sure exists. As the intended beneficiaries, COPE members ask that, if the Commission is to adopt a final rule based on the Position Limits NOPR, it make the rule as simple, clear, and non-disruptive to commercial business as possible.

As set forth in more detail below, the Position Limits NOPR should be changed as follows:

- The position limits regime enacted should be closely tailored to address the concerns identified by the Commission.

- The Commission should specify all specific referenced contracts covered by position limits.

- Financially-settling swaps and commodity options/trade options should be excluded from position limits (without question trade options should be excluded).

- The scope of hedges permitted to exceed the limits should track the scope of hedges exempted from the Dodd-Frank clearing requirement through the End User Exception.

- If the enumerated *bona fide* hedge regime is adopted, it should be expanded and liberalized to include the hedging actually used by commercial companies to mitigate their risks.

[10] In the Position Limits NOPR, a “referenced contract” includes the enumerated core referenced futures contracts, as well as futures, options, or swaps that are directly or indirectly linked to the price of a core referenced futures contract, or the price of the same commodity underlying a core referenced futures contract for delivery at the same location. *See* Position Limits NOPR at 75825 (proposed definition of “referenced contract”).

- The reporting required should be as simple as possible and the Commission should develop a clear rulebook with input from end user /hedgers to create an understanding of what is required in such filings by both the regulator and the regulated.

Is the Cure Worse Than the Disease?

Given COPE members' vantage point as physical companies regularly using the covered contracts for hedging, one would expect them to have observed harm caused by excessive speculation which would be controlled by the regime proposed in the Position Limits NOPR. COPE members have, on occasion, experienced increased costs of hedging caused by directional movements in commodities markets due to broad-based interest in commodities as an asset class (a topic which is not the subject of the Position Limits NOPR). However, absent the very limited and specific instances of manipulative schemes on a DCM, such as those identified by the Commission (which have occurred notwithstanding exchange position limits), COPE members have not seen harmful price movements due to specific entities holding a concentrated position in the core referenced futures contracts or, more important to this proposal, holding positions in economically equivalent futures, options, or swaps (including trade options).

The Position Limits NOPR explores the academic record, cataloguing concerns about excessive speculation in these markets and the potential viability of aggregate position limits as a remedy.[11] After evaluating the academic record, the Commission has found that the "studies overall show a lack of consensus regarding the impact of speculation on commodity markets and the effectiveness of position limits."[12] To the degree the Commission finds support for position limits, the scenarios it points to do not relate to excessive speculation as such but, rather, to discrete manipulative schemes conducted by the Hunt family[13] and Amaranth Advisors.[14] Instead of representing excessive speculation, these two examples relate to very particular activities undertaken for the purpose of driving prices in a manipulative scheme. They do not concern speculation in commodities in hopes of benefiting from price appreciation. Effectively, by relying on these examples, the Commission appears to be targeting manipulation in the Position Limits NOPR, not excessive speculation.

Given the foregoing, COPE is unsure as to what the Commission intends when it refers to excessive speculation. Does it solely intend the type of position accumulation related to the Hunt/Amaranth manipulative schemes? Does it mean broad based, asset class related speculation that has affected prices?[15] Does it mean both and/or something else?

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[11] *See, e.g.,* Position Limits NOPR at 75694-95.

[12] *Id*. at 75695.

[13] *Id*. at 75685-91.

[14] *Id*. at 75691-93.

[15] With respect this topic in the Commission's prior position limit proposal, COPE stated:

> Importantly, if the Commission is concerned about speculation, it should address that topic rather than merely focus on concentration. In the period between mid-2007 and the third quarter of 2008, investors concerned about equity and bond market valuations (as well as currencies) were looking for another "asset class" in which to invest. Many investors took the view that global market dynamics, driven

These questions are important because the Position Limits NOPR does not address the broad based, asset class related speculation that has affected prices. It appears to be limited to concentrations held by particular parties for the purpose of market manipulation without regard to generalized "excessive speculation." If the Commission is concerned about persons acquiring a concentrated position for the purpose of manipulating the futures market closing price (as in Amaranth) or hoarding physical inventory (as in Hunt), COPE believes there are targeted and less burdensome and complex ways to prevent such a manipulative harm.[16] In fact, Dodd-Frank has given the Commission new and powerful authority to combat manipulation.[17] If the Commission is concerned about broad based, asset class related speculation, its proposal is deficient as it does not address the price impact of speculative money flows into commodities.

The Commission's proposal includes futures and options traded on DCMs as well as financial and physical swaps (including trade options). Futures and options are subject to exchange position limits today and will continue to be under the Position Limits NOPR. Given the focus of the Position Limits NOPR on using position limits to target manipulation of price discovery markets or hoarding physical inventory, COPE does not believe that the Commission has articulated a nexus between the purported goals of its position limits proposal and the inclusion of swaps and trade options which, as COPE understands the Commission's concerns, cannot be used to distort market prices though excessive speculation.

Under the Position Limits NOPR, financially settling swaps are subject to position limits if they are economically equivalent to a core referenced futures contract. The Commission has not explained, and COPE is uncertain, how a person can speculate in such swaps (which can exist in unlimited numbers and do not serve a price discovery function) in a manner that can cause the detrimental market impact the Commission is seeking to address. The same is true for commodity options and, in particular, trade options. As set forth in more detail below, trade options are commercial contracts typically entered into to provide for variable supply needs of physical commercial businesses. Trade options and other commodity options are not price discovery contracts. The Commission has not explained (and COPE does not see) how commodity options/trade options can be used for detrimental excessive speculation of the type

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> by developing economies such as China and India, would push up commodity prices as demand for energy and agricultural products increased. As such, they looked to invest in the "commodity asset class." This group of investors (such as pension funds, money managers , hedge funds, individuals, and others) did not typically hold large individual concentrations. They did, however, collectively and speculatively invest directionally the same in a significant way by "going long commodities." Without expressing an opinion as to whether this speculative investment was "excessive," it did not necessarily involve individual traders holding large concentrations. The proposed rule does not address these facts or similar speculative investments in any way.

Comments of the Coalition of Physical Energy Companies, RIN Nos. 3038-AD15, 3038-AD16 (Mar. 28, 2011), at 4.

[16] COPE notes that Amaranth was able to undertake its manipulative scheme even though position limits were in effect on the exchange.

[17] *See* Dodd-Frank § 753 (Anti-Manipulation Authority); 17 C.F.R.§§ 180.1, 180.2 (Prohibition Against Manipulation).

identified by the Commission or how including them in a position limits regime can serve to benefit commodity markets and the consumers position limits purport to serve.

COPE is unaware of any contentions that financially settling swaps and commodity options/trade options are problematic vehicles for speculation which may harm commodity markets. For COPE members, inclusion of such contracts in the Position Limits NOPR is the most problematic component of the proposal. These contracts are often bespoke and more difficult to track than specified exchange-traded agreements. As futures and options are already subject to exchange position limits, COPE suggests the Commission focus on improving such limits or replacing them with federal limits. Unless the Commission can articulate a nexus to the problem it is trying to solve with their inclusion, financially settling swaps and trade options should not be included as covered by position limits in a final rule.

Thus, it is incumbent upon the Commission to provide support not only for its contention that excessive speculation requires a position limits regime, but also for the notion that the regime proposed in the Position Limits NOPR will properly address the identified harm. In doing so, it should consider the complexity and burden it is placing on the commodity end user/hedgers that will be significantly impacted by the tracking and paperwork components of the proposal and balance them against the benefit provided. Unless the Commission can tie financially settling swaps and commodity options/trade options to the excessive speculation which position limits are proposed to remedy, it should drop these contracts from the scope of the final rule.

Referenced Contracts Should Be Individually Specified

In addition to subjecting the enumerated core referenced futures contracts to position limits, the Position Limits NOPR also includes "referenced contracts." Those contracts are proposed to be defined as:

> "on a futures equivalent basis with respect to a particular core referenced futures contract, a core referenced futures contract . . . , or a futures contract, options contract, or swap, [subject to certain exclusions]:
>
> . . . That is:
>
> (i) Directly or indirectly linked, including being partially or fully settled on, or priced at a fixed differential to, the price of that particular core referenced futures contract; or
>
> (ii) Directly or indirectly linked, including being partially or fully settled on, or priced at a fixed differential to, the price of the 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.[18]

The concept behind the scope of the "referenced contract" label is that they are to be economically equivalent to the related core referenced futures contract.[19] Thus, a related option

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[18] Position Limits NOPR at 75825.

[19] *See id.* at 75685, fn 59 ("Thus, while Congress made the threshold decision to impose position limits on physical commodity futures and options and economically equivalent swaps, Congress at the same time delegated to the Commission the task of setting the limits at levels that would maximize Congress' objectives.").

or "look-alike" swap should be captured as a referenced contract since such transactions reflect the same commodity in a transaction that operates in an economically similar manner to the core referenced futures contract. However, rather than including only economically equivalent contracts, the proposed definition will require the inclusion of transactions that do not have economic equivalence to a core referenced futures contract, as well as including commodities other than that which is the subject of a core referenced futures contract.

The criteria for referenced contract status does not appear to require any measure of economic equivalence. It is entirely based upon a direct or indirect[20] reference to a core referenced futures contract or the delivery location thereof. That limited link should be the starting place for economic equivalence, but not the entire analysis. It is entirely possible that a contract so linked (even in the same underlying commodity) could have other features that cause it to be non-correlated and economically distinct from the core referenced futures contract with which it will be counted for position limits purposes.

Beyond the lack of economic equivalence of all contracts in the same commodity, both swaps and trade options can be structured to use core referenced futures contract prices and components of transactions that are ultimately expressed *as different commodities*. This is particularly true when the core referenced futures contract is a fuel or other input in the creation of another commodity. An example of the foregoing is a heat rate option, which can be financial or physical. A heat rate option uses a formula that mimics the incremental costs of production of a power plant. One of the inputs will be the price of the fuel component (which may be a core referenced futures contract or other reference captured by the proposed definition of referenced contract for natural gas or fuel oil). The heat rate option referencing oil or natural gas is expressed in dollars per megawatt hour of electricity. Similarly, an ethanol contract may include input prices for agricultural core referenced futures contracts. The physical or financial ethanol contract is expressed as dollars per barrel of ethanol. While these are different commodities than that covered by the core referenced futures contract and the price expressed for such commodities is the product of multiple inputs, the Position Limits NOPR deems them *per se* economically equivalent to the core referenced futures contract.

The referenced contract definition includes any contract that is directly or indirectly linked to or uses the same delivery location as a core referenced futures contract. There is no requirement of any price correlation or other criteria that would logically tie the contracts together in a single position for the stated purpose of the Position Limits NOPR. All that exists is a one-size fits all definition that is overbroad and captures contracts that are not in any way economically equivalent to a core referenced futures contract.

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[20] COPE also requests that the Commission clarify what is meant by "indirectly" in the definition of "referenced contract." It is one thing if the Commission means a reference to a contract that itself directly references a core referenced futures contract. It is more troubling and likely unworkable if the Commission means a more subjective economic link to a delivery location that is used in a core referenced futures contract. At a minimum, the Commission should provide examples of indirect linkage that triggers referenced contract status.

By contrast, the Commission has published a non-exclusive list of referenced contracts.[21] A review of the published list reveals that the designated contracts appear to be thoughtfully reviewed and arguably economically equivalent to the core referenced futures contract to which they are linked. In addition, these contracts are exchange-traded with a stated designation that make them susceptible to tracking and aggregation in real-time as required by the Position Limits NOPR. This list illustrates that while some specific contracts appropriately fall within the proposed definition of referenced contract, the over-broad definition captures many more contracts that may be bespoke, over the counter, and otherwise bear little actual similarity or linkage to the core referenced futures contract, much less feature anything approaching economic equivalence.

COPE believes that the Commission should limit referenced contracts to a specific list of enumerated contracts. That way, contracts without economic equivalence will not be captured, there will be no ambiguity as to what is in and what is out, and compliance will be simplified by creating a clear set of contracts that establish a "position" to which the aggregate limits apply. In addition, the Commission will have transparency into the positions of traders, since the Commission's list of referenced contracts is made up of exchange-traded contracts, and swaps and commodity options/trade options which do not give rise to the excessive speculation/manipulation issues the Commission is addressing with the proposal will not be included.

Trade Options Should Be Excluded From Position Limits

In its order and final rules establishing the criteria for trade options,[22] the Commission limited swap regulation applicable to trade options to a subset of regulatory requirements. Included in the elements to be applied to trade options is position limits.[23] While it included them, the Commission did not provide any rationale to extend position limits to trade options. In the Position Limits NOPR, the Commission has sought comment on whether trade options should be subject to position limits in the final rule.[24] As the nature of trade options is such that they are, by definition, unrelated to speculation (much less excessive speculation), they should be excluded from the definition of "referenced contract" and thus from position limits.

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[21] See Position Limits Workbook, Commodity Futures Trading Commission, http://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/PositionLimitsforDerivatives/ssLINK/poslimitsworkbook.

[22] *Commodity Options*, 77 Fed. Reg. 25320 (April 27, 2012); 17 C.F.R. § 32.3 (2013).

[23] *Id.* at § 32.3(c)(2); *see also* Position Limits NOPR at 75711.

[24] *Id.*

Trade options are required to meet the following criteria:

> (1) Such commodity option transaction must be offered by a person that has a reasonable basis to believe that the transaction is offered to an offeree as described in paragraph [(2)] . . . . . In addition, the offeror must be either:
>
> (i) An eligible contract participant . . . ; or
>
> (ii) A producer, processor, or commercial user of, or a merchant handling the commodity that is the subject of the commodity option transaction, or the products or by-products thereof, and such offeror is offering or entering into the commodity option transaction solely for purposes related to its business as such;
>
> (2) The offeree must be a producer, processor, or commercial user of, or a merchant handling the commodity that is the subject of the commodity option transaction, or the products or by-products thereof, and such offeree is offered or entering into the commodity option transaction solely for purposes related to its business as such; and
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> (3) The commodity option must be intended to be physically settled, so that, if exercised, the option would result in the sale of an exempt or agricultural commodity for immediate or deferred shipment or delivery.[25]

As can be seen from the foregoing criteria, trade options are (by definition, as created and applied by the Commission) physically settled agreements between commercial parties for their use in the ordinary course of business. The concept of trade options exists to permit commercial parties to satisfy their physical business needs using physical agreements that are not subject to the full range of commodity option regulation – not to speculate. Those needs typically relate to the ability to require delivery in conjunction with the real-time physical needs of a business. Simply stated, operators of physical businesses often require contracts that permit them to meet the supply needs of their business (an option to require delivery of a commodity used as an input to an industrial process or resold to wholesale or retail customers) or the ability to offload a commodity that they have purchased but do not need (an option to reduce the level of purchase of a commodity in the wake of reduced demand). Trade options are by the Commission's own definition over-the-counter agreements between commercial parties that make and take delivery of the commodity in question. Given their physical nature, the ability of a counterparty to meet its physical obligations is critical to parties entering into trade options, and is integral to qualification as a trade option.

For example, in the energy business, commercial parties may enter into trade options in the following sample scenarios:

> (1) a power plant owner may enter into an option for physical power to assure it has power to supply its customers in the event its power plant experiences an outage or an option for fuel that allows it to modify the volumes of delivery to meet demand;
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> (2) a natural gas distribution company may enter into an option for physical natural gas to meet winter peaking needs of its system;

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[25] 17 C.F.R §§ 32.3(a)(1)-(3).

(3) a refiner may enter into an agreement under which crude oil is delivered to its facility at a fixed price with the ability to set volume at a time near to delivery when the precise demand and capacity of its refinery is known; or

(4) a natural gas storage customer may enter into an option to sell its natural gas at a fixed price in case if the heating season is unusually warm and demand (and thus price) is weak.

Each of these trade options examples exists in conjunction with *bona fide* physical commercial business and is used to prudently supply or control inventory. As can be seen from the foregoing, these are not used for speculation as contemplated by the Position Limits NOPR. In fact, if they were used for speculation they could not meet the definition of a trade option. The Commission has never provided any logical basis or rationale to include trade options in position limits.[26]

Since the purpose of position limits is to prevent excessive speculation in contracts that are generally used for price discovery, inclusion of over-the-counter physical trade options used in commercial business in the position limits regime serves no purpose. Inclusion of trade options will only result in further complexity[27] (for example, how does the Commission intend persons to calculate the futures equivalent amount of a trade option?) and create unnecessary burdens on physical commercial end users that do not engage in the types of speculation the Commission is seeking to prevent. Trade options should not be included in any final rules based on the Position Limits NOPR.

Real Hedging Is More Than Just The Enumerated *Bona Fide* Hedges

In its comments to the Commission's initial position limits proposal, COPE requested that the Commission utilize the definition of "hedging or mitigating commercial risk" for the end-user exemption to mandatory clearing and Major Swap Participant determination rather than the complex and incomplete "enumerated hedges" it had proposed.[28] COPE continues to believe that the Commission should simplify its regulatory scheme and use the common-sense and workable definition of "hedging" it has created for those elements of its regulation here. Simply stated, *if it's hedging – then it's hedging*. Hedging that qualifies for opting out of the clearing that is otherwise unambiguously mandatory under the Dodd-Frank statute is no less legitimate, non-speculative, or *bona fide* than hedging that is exempt from the Commission's regulatory position limits.

When commercial firms act to hedge their risk, they approach the issue in the common sense manner that the definition of "hedging or mitigating commercial risk" for the end-user

[26] If the Commission desires to include Trade Options in a position limits final rule, it must justify such inclusion. It is a giant leap to move from exchange-traded contracts among which academics have debated the utility of position limits to physically-delivering trade options where no one has seriously suggested any value for position limits.

[27] Physical agreements that may qualify as trade options are already subject to the highly problematic 7 part test included as part of the Commission's definition of the term "swap."

[28] COPE 2011 Position Limits Comments at 10.

exemption and Major Swap Participant determination has captured.[29] The hairsplitting and stylized elements of enumerated *bona fide* hedging transactions proposed in the Position Limits NOPR will require a new mindset that is not related to addressing commercial needs but, rather, subordinates legitimate commercial decisions to hard-wired regulatory requirements. As such, COPE believes that the Commission has it backwards. Real world hedging recognized by the Commission as *not speculation*, sufficient to opt out of clearing, and sufficient to not be counted towards an entity's exposure for purposes of the Major Swap Participant definition, should by definition meet the "hedging" test to exceed position limits.[30] Put another way, the Commission has not explained any reasonable rationale as to why a given transaction qualifies as a non-speculative hedge that is exempt from the Dodd-Frank rule of mandatory clearing, while that same transaction fails to qualify as a *bona fide* hedge and must be counted with speculative positions for purposes of the proposed position limits. And yet that is exactly the result of the incongruous, narrow, and intricately specific definition of *bona fide* hedge that the Commission has proposed.

Currently, DCMs evaluate requests to grant hedge exemptions in a facts and circumstances manner taking into account the commercial business activities of an end-user/hedger. This process takes into account the magnitude of the hedging needs of a firm and the utility of a futures contract to meet those needs before they grant a hedge exception. COPE members have found that this process has proven workable and allows end-user/hedgers to undertake legitimate risk management in the context of exchange position limits. However, due to the one size fits all nature of the enumerated hedges, it appears that certain activities that currently warrant an exchange hedge exemption will not qualify as enumerated *bona fide* hedges under the Position Limits NOPR regime, leading to irrational and unworkable outcomes. Specifically, proposed Section 150.5 provides that DCMs and SEFs shall set speculative position limits "no higher than the level" set by the Commission for Referenced Contracts, and "[a]ny hedge exemption rules adopted by a [DCM of SEF] . . . must conform to the definition of bona fide hedging" developed by the Commission.[31] As COPE understands it, this proposal will upend the generally workable and long-standing exchange-based position limit and *bona fide* hedge exemption system that has long permitted energy market participants to efficiently hedge their risk.

As a result, the proposed position limits regime carries with it the distinct possibility of disrupting the currently workable and well-understood process which assures compliance with position limits while respecting legitimate hedging. As it considers its final action on a position limits rule, the Commission should strive to limit complexity and assure that legitimate hedging can continue without interference. For example, the Commission could permit companies that have received exchange-granted hedge exemptions to use the resulting position limit as those companies' position limits for purposes of federal position limits.[32]

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[29] *See* 17 C.F.R. §§ 50.50(c) (defining "hedging or mitigating commercial risk" for purposes of the end-user exception to clearing), 1.3(kkk) (defining "hedging or mitigating commercial risk" for purposes of the Major Swap Participant determination).

[30] *See id.*

[31] Position Limits NOPR at 75829 (proposed §§ 150.5(a)(1), (2).

[32] Today's exchange-granted hedge exemptions are normally set on an annual basis after an application by the company seeking the exemption. This provides two advantages. First it allows the

The Commission devotes significant space in the Position Limits NOPR to *bona fide* hedges.[33] Effectively, the Commission provides high level concepts that guide qualifications as a *bona fide* hedge, and also limit *bona fide* hedges to those specific transactions enumerated in the proposal. Included in the high level concepts is a requirement that positions meet an incidental test[34] (hedged risk arises from commercial cash market activities) and an orderly trading requirement (duty of care when entering into or exiting *bona fide* hedges).[35] While the high level elements provide context to *bona fide* hedging, the enumerated hedges are the real requirements of whether a position is a *bona fide* hedge for position limits purposes.

In addition, the enumerated hedges approach proposed by the Commission implicitly requires that each transaction be directly and uniquely associated with the cash market risk that has arisen. However, this construct will not always work. Commercial parties are managing physical businesses that gives rise to risks that can be ameliorated via prudent and efficient hedging. The risks are not discrete, but flow from the overall business. For example, a natural gas producer may have a portfolio of production in various locations, which it views as a combined and aggregate risk profile. Thus, rather than drill down to well-by-well hedging, it will risk-manage its production on a portfolio basis.

Such portfolio hedging fits nicely within the "hedging or mitigating commercial risk" construct of non-speculative hedging that is exempt from mandatory clearing, as designed by the Commission. By contrast, this real-world concept of hedging does not necessarily fit within the narrow and artificial confines of the proposed enumerated hedge regime. The risk being hedged is not, for example, a discrete sale under a specific fixed price contract (with a corresponding and neatly-fitting enumerated hedge) but, rather, a set of risks emanating for a portfolio, perhaps including some fixed price contracts. It is therefore difficult to sync up the transactions used to hedge such aggregate risk with the enumerated hedges that appear focused on transaction-level risk management. The danger of limiting and curtailing legitimate portfolio hedging is a further reason to adopt a less restrictive and more realistic *bona fide* hedging regime than that proposed in the Position Limits NOPR.

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applicant to describe and justify its hedging needs and practices in a way that cannot be done on the "after the fact" reports proposed by the Commission. Second, having a predetermined limit for an annual period provides more certainty that positions indeed will be recognized as *bona-fide*. Again, carrying this well-understood and effective process forward under the new rule would facilitate compliance. The Commission and the exchanges could at any time examine the positions being held under the exemptions to ensure that they indeed represented bona-fide hedging.

[33] Position Limits NOPR at 75702-23.

[34] *See id.* at 75823 (proposed § 150.1, Definition of "*Bona fide* hedging position" includes "any position whose purpose is to offset price risks incidental to commercial cash, spot or forward operations . . .").

[35] *Id.* ("[A]nd such position is established and liquidated in an orderly manner in accordance with sound commercial practices.").

<u>The Orderly Trading Requirement Should Be Eliminated for End-User/Hedgers and Should Not Apply To Over The Counter Markets</u>

Before addressing the enumerated hedges, COPE will address the application of the concept of orderly trading to the activities commercial parties have historically taken to hedge their commercial commodity risks. As noted above, COPE members are commercial parties that access the futures, options, swaps, and physical markets to manage risk and otherwise efficiently operate their commercial businesses. When they need to hedge, they hedge (on exchanges or over-the-counter). When they engage in physical trades of the type captured by the proposed rule, they do so in the normal course as they have typically done. Now the Commission is proposing that in order for transactions to qualify as *bona fide* hedges for position limits purposes, they be subjected to an orderly trading requirement establishing a duty of care when trading on exchanges *or in over-the-counter financial and physical markets.*

This standard is inapposite for the purposes of position limits and inappropriate for over-the-counter markets. Commercial firms that are hedging their risks do so in conjunction with those risks arising in the normal course of business. Aside from seeking advantageous pricing, they do not typically monitor market activity or engage in material trading. They participate in markets; they don't move markets. By placing an orderly trading obligation on such firms, the Commission is effectively making them market fiduciaries, which implies that they must, on a real time basis, monitor market activities and ensure that they somehow do not "cause a significant market impact" with their otherwise legitimate hedging (causing then to lose *bona fide* hedge status).[36]

Further, while COPE understands (but does not support) the potential application of this proposal to exchange-traded products, it sees no apparent application to over-the-counter physical or financial markets that do not serve significant price discovery functions. The Commission gives no indication of what orderly trading means in a bilateral physical or financial market. Nevertheless, the Commission appears to be obligating those engaging in such trades to figure out the meaning and somehow be market fiduciaries for such markets.

COPE has no objection to the Commission's anti-disruptive trading prohibitions and polices which will apply regardless of whether the orderly trading requirement is imposed here.[37] Those policies are clearly articulated and targeted in a direct and meaningful way to prevent the types of disruptions identified here as well as the types of persons that might cause disruptions. Further, those policies are, correctly, limited to exchange trading – not over-the-counter transactions. The Commission should not import such policies to create the potential risk of inadvertent non-compliance to those engaging in legitimate hedging, as a result of the basic inapplicability of those concepts to the over the counter commodities markets. Thus, the Commission should remove the orderly trading component from its proposal.

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[36] *Id.* at 75707 (orderly trading requirement intended to avoid a "significant market impact in establishing, maintaining or liquidating a position in excess of position limitations").

[37] *See Antidisruptive Practices Authority*, 78 Fed. Reg. 31890 (May 28, 2013) (Interpretive guidance and policy statement).

Assuming That the Enumerated *Bona Fide* Hedge Approach Is Adopted, Additional *Bona Fide* Hedges Are Needed

While COPE believes that the Commission should not proceed with the proposal to require market participants to meet specific transaction criteria in the form of the enumerated *bona fide* hedges in order to establish *bona fide* hedge positions, if the Commission proceeds with this approach it should reconsider its rejection in the Position Limits NOPR of various proposed enumerated *bona fide* hedges actually used by commercial market participants. Restricting the definition of "*bona fide* hedge" to the proposed enumerated transactions does not capture many transactions that market participants like the members of COPE utilize to hedge commercial risk, and the Commission should, at a minimum broaden the list of enumerated hedges to include the following transactions. One of the following requested enumerated *bona fide* hedges was adopted by the Commission itself in the Prior Rule. The rest were requested in a petition filed with the Commission by the Working Group of Commercial Energy Firms (the "Working Group Petition")[38] and rejected in the Position Limits NOPR.

(1) Unfilled Storage Capacity

The Commission determined not to re-propose the Unfilled Storage Capacity enumerated hedge from the Prior Rule.[39] That exemption would have allowed as a *Bona Fide* Hedge offsetting sales and purchases of commodity derivative contracts that did not exceed the amount of the same commodity that was anticipated to be merchandized, and was limited to the current or anticipated amount of unfilled storage capacity that the person owned or leased.[40] The Commission has not re-proposed this Enumerated *Bona Fide* Hedge based on its view that the value fluctuations in a calendar month spread in a commodity derivative contract will likely have "at best a low correlation" with value fluctuations in expected returns on unfilled storage capacity.[41]

COPE disagrees with the Commission that value fluctuations in expected returns from merchandizing a commodity would have a low correlation with storage capacity value. Physical energy companies regularly engage in merchandizing natural gas, oil, refined products and other commodities from storage capacity which they own or pay reservation charges to maintain. With the seasonal variations in demand that are common with energy products, it is essential to maintain storage capacity that is the basis of a logistical physical business permitting timely and profitable merchandizing. In order to profitably acquire the stored commodity for later sale, the physical company will often fix its price of supply to be stored using derivatives. That way, it can access liquid markets to hedge its purchase and effectuate its physical purchase in a timely manner and within physical constraints without concern of market risk. The result is the prudent purchase of the required commodity, constrained by the size of storage, for future merchandizing. Such transactions are not speculative or in any way tied to gaming or

[38] *Working Group of Commercial Energy Firms Petition for Commission Order Granting Exemptive Relief for Certain Bona Fide Hedging Transactions Under Section 4a(a)(7) of the Commodity Exchange Act* (Jan. 20, 2012) ("Working Group Petition").

[39] *See* Position Limits NOPR at 75719.

[40] *See* Prior Rule at 71688 (Regulation 150.5(a)(2)(v), vacated).

[41] *See* Position Limits NOPR at 75719.

manipulation of the markets; on the contrary, they are an integral part of the hedging required to guard against future price swings in commodities for merchants engaged in sales of those commodities. This is standard market behavior and was previously recognized by the Commission as such. Accordingly the Commission should include such activity as "*bona fide* hedging", as was the case with the Commission's prior position limits rule.

(2) Working Group Request #3: Unpriced Physical Purchase or Sale Commitments[42]

This requested enumerated *bona fide* hedge would include positions used to lock in a price differential where one leg of the underlying transaction is an unpriced commitment to buy or sell a physical energy commodity, and the offsetting sale or purchase has not been completed.[43]

In the Position Limits NOPR, the Commission expressed the view that in this scenario a trader has not established a definite exposure to a value change, since the trader has established only an unfixed price purchase or sales obligation.[44] The Commission further expressed concern that this would "make it difficult or impossible for the . . .to distinguish hedging from speculation."[45] On the contrary, as explained by the Working Group Petition, even though the price remains unfixed, there are economic factors that drive market participants to enter into firm physical commitments that are ancillary to the final price, such as the cost of transportation, insurance, interest, and market conditions.[46] Those factors are not speculative in any sense, and market participants utilize derivatives to lock in the various economic conditions and factors driving them to enter into an as-yet unfixed price commitment. Market participants utilizing derivatives in this manner are no more engaged in speculation than if their price commitment were fixed at the time of the hedge. For this reason, the Commission should include the Working Group's request #3 among the enumerated *bona fide* hedges.

(3) Working Group Request #4: Binding, Irrevocable Bids or Offers

This would encompass positions used to hedge exposure to market price volatility associated with binding and irrevocable fixed-price bids or offers.

The Commission stated in the Position Limits NOPR that a "binding bid or offer . . . is too tenuous to serve as the basis for an exemption from speculative position limits."[47] In the course of real-world marketing of energy commodities, a binding bid or offer to supply or purchase a commodity at a fixed price is anything but tenuous. Rather, such bids or offers entail a firm commitment that must take into account forward price curves and margin variability.[48] Hedging such commitments using derivatives is not rendered speculative by the fact that the commitment remains subject to acceptance by another party; the economic risks incurred in making the

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[42] COPE notes that the term "unfixed" price, is not commonly used in the energy industry. Such pricing is normally referred to as "index" or "floating."

[43] *See* Working Group Petition at 6.

[44] Position Limits NOPR at 75719.

[45] *Id*.

[46] Working Group Petition at 6.

[47] Position Limits NOPR at 75720.

[48] *See* Working Group Petition at 8.

binding bid or offer are the same as if the commitment were made, and as such the Commission should include the Working Group's request #4 in any final set of enumerated *bona fide* hedges.

(4) Working Group Request # 5: Hedging of Positions Subject to Negotiation

The Working Group requested that an enumerated *bona fide* hedge be included that captures positions used to hedge a physical commodity transaction that is subject to ongoing, good faith negotiations which the hedging party reasonably expects to conclude.

Like Working Group Request #4, explained above, COPE believes that this request reasonably reflects commercial realities, in which market participants must at times place hedges based on reasonable, good faith judgments regarding future commodity price risks arising from transactions that may remain subject to some further negotiation. Physical commodity transactions are fluid, and the realities of the physical and derivatives markets are such that the optimal time to place a hedge to guard against price fluctuations may occur prior to the final execution of an agreement from which that risk arises. Market participants should not be hamstrung in their ability to respond to market conditions to properly hedge their risk by the exclusion of such positions from the definition of "*bona fide* hedge." The fact that a transaction has yet to be finally completed, where the party hedging that position reasonably believes the transaction to be completed, does not change a potential hedging position into a speculative position that should be subject to position limits. On the contrary, COPE strongly believes that the Commission must consider commercial realities and not draw arbitrary distinctions that wrongly exclude certain hedges from the scope of *bona fide* hedges, if it insists on pursuing a structure where a transaction must be an enumerated *bona fide* hedge to be considered a real "hedge" for position limits purposes.

(5) Working Group Request #7: Hedging Physical Positions Using Calendar Month Average ("CMA") Pricing

This request would include as an enumerated *bona fide* hedge a position held as a hedge in connection with a CMA pricing structure.

As explained by the Working Group petition and the examples set forth therein, CMA transactions are not speculative in nature, and are utilized frequently in the energy commodities markets to hedge legitimate risk arising from commerce.[49] Despite the Commission's complex analysis of whether, in certain hypothetical scenarios, such CMA transactions would qualify under the various proposed enumerated *bona fide* hedges,[50] COPE agrees with the Working Group that such transactions are so common and integral to legitimate hedging of energy commodity transactions, that market participants cannot rely on a piecemeal application of the proposed enumerated hedges, and require a specific enumerated *bona fide* hedge to capture these transactions. As the Working Group's petition explained, CMA transactions generally involve buying and selling physical delivery Referenced Contracts and potentially holding these positions in the last three days of trading. Such transactions are integral to physical businesses, and are not used in a speculative manner.

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[49] *See id*. at 14.

[50] *See* Position Limits NOPR at 75721-22.

(6) Working Group Request #9: Holding a Cross-Commodity Hedge Using a Physical Delivery Contract Into the Spot Month.

The Working Group opposed the proposed application of the Commission's "five-day rule" with respect to enumerated cross commodity hedges in its petition in response to the previous position limits proposal, restricting the availability of that enumerated *bona fide* hedge for cross-commodity transactions if such positions are held in physical delivery contracts into the spot month period.[51]

COPE believes that the application of the "five-day rule" to this or any of the enumerated *bona fide* hedges is not necessary or appropriate to achieve the Commission's stated goal of imposing position limits to combat excessive speculation and resulting potential market manipulation. COPE believes that any position in physical delivery referenced contracts that is a qualifying *bona fide* hedge outside the spot month period should remain as such in the spot month period. The utility of a position as a hedge against physical price risks does not cease once the spot month period begins, nor is a position rendered speculative simply because the spot month period has begun.

Further, and importantly, physical companies may hold physical delivery contracts with the intention of taking physical delivery. Taking physical delivery (or "EFP"ing) a futures contract is as far from speculating as possible. Application of the five day rule can have the effect of providing a position limits barrier to these non-speculative physical transactions. Effectively, to combat speculation by potential manipulators, real world physical companies that are trying to operate a business prudently can (and will) lose access to physical supply by the proposed application of the five day rule.

<u>A Timely Process to Add *Bona Fide* Hedges Is Needed</u>

As noted above, the Commission's adoption of an enumerated hedging regime for the qualification of *bona fide* hedges is too narrow to capture all of the legitimate hedging activity undertaken by commercial firms. In addition to limiting *bona fide* hedging to the enumerated hedges, the Commission proposes to expand the list of enumerated hedges by way of notice and comment rulemaking,[52] and a process to seek prior exemptive relief from the Commission through a petitions (although it seeks comment on alternative means).[53] This indicates that the process to alter the list of *bona fide* hedges will be difficult and time consuming.

We have already had experience with attempts to modify the Commission's list. On January 20, 2012, the Working Group of Commercial Energy Firms filed a petition for a Commission order granting exemptive relied from position limits for certain enumerated transactions which was

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[51] *See* Working Group Petition at 20.

[52] *See* Position Limits NOPR at 75718 ("Under the proposal for hedges of physical commodities, additional enumerated hedges could only be added to the proposed definition of bona fide hedging position by way of notice and comment rulemaking.").

[53] *See id*. at 75828 (proposed § 150.3(e)(2)); *id.* at 75718.

supported by multiple parties, including COPE.[54] The petition suggested ten new *bona fide* hedges (some of which have been adopted by in the Position Limits NOPR) for the position limits regime that was to go into effect under the Prior Rule on October 12, 2013.[55] However, given the need to institute processes and prepare to comply with the position limits regime, the Commission would have had to have acted long before October 12, 2012 if it were to timely address the petition in support of the October 12th date. It didn't happen then in a timely manner, and COPE is skeptical it will happen now in time for market participants to comply with a new position limits regime.

It is COPE's view that the approach contained in the Position Limits NOPR is too time consuming to work. The Commission, if it must have an enumerated hedge regime, should make provision in the final rule that, upon a properly supported application, the Commission or, by delegation, the Director of the Division of Market Oversight ("DMO") can timely place temporary enumerated *bona fide* hedges in effect, subject to comment by the public which will become permanent unless revoked by the Commission within a specified time period. The standard to be used for such additional *bona fide* hedges could be a direct and straightforward application of the incidental test articulated by the Commission as a high level measure of the utility of a transaction to hedge cash market risk.[56] This way, legitimate, *bona fide* hedges brought to the Commission or DMO's attention can be made effective on a timely basis.

<u>Cross-Commodity Hedges Should Not Be Subject to a Quantitative Test.</u>

The Position Limits NOPR permits a *bona fide* hedge in a cross-commodity derivative contract:

> to offset the risks arising from a commodity other than the same cash commodity underlying a commodity derivative contract, *provided that* the fluctuations in value of the position in the commodity derivative contract, or the commodity underlying the commodity derivative contract, are substantially related to the fluctuations in value of the actual or anticipated cash position or pass-through swap…[57]

The foregoing *bona fide* hedges appear to recognize the fact the often there is not a liquid derivative contract available to hedge legitimate cash market commercial risk for a particular commodity. Thus, the regulation provides that as long as the value fluctuations of derivative contract are *substantially related* to the risk being hedged, the contract can be used as a *bona fide* hedge. However, the Commission has further qualified the "substantially related" requirement with both qualitative and quantitative tests which, if not met, will result in a rebuttable presumption that the contract is not a *bona fide* hedge.[58]

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[54] *See, e.g., Letter of the Coalition of Physical Energy Companies in Support of the Petition for Exemptive Relief from Certain Bona Fide Hedging Transactions of the Working Group of Commercial Energy Firms*, Feb. 27, 2012.

[55] The District Court vacated the Prior Rule on September 28, 2012, and the Commission did not act on the Working Group Petition.

[56] *See* Position Limits NOPR at 75707.

[57] *Id*. at 75824 (emphasis in original).

[58] *Id*. at 75716-17.

The quantitative test is whether the target commodity has a reasonable commercial relationship to the commodity underlying the commodity derivative contract.[59] The quantitative test is whether the target commodity has reasonable quantitative correlation underlying the commodity derivative contract "in light of available liquid commodity derivative contracts" such that:

> the correlation (R), between first differences or returns in daily spot price series for the target commodity and the price series for the commodity underlying the derivative contract (or the price series for the derivative contract used to offset risk), is at least 0.80 for a time period of at least 36 months.[60]

If the hedge fails these tests, a person can seek relief under Section 140.99.[61]

The Commission's proposal ignores commercial reality and will significantly burden commercial hedgers. The Commission should recognize that cross-commodity hedges are not used because hedgers prefer them to contracts in the same commodity. They are used because there is no satisfactory liquid contract in the same commodity. For example, crude oil is often used to hedge natural gas liquids and natural gas is often used to hedge electricity. While these contracts may be the best fit available, the contract used to hedge may not be correlated at 0.80 for a time period of at least 36 months. Removing these contracts from the list of *bona fide* hedges (absent a time consuming and expensive Section 140.99 process which is foreign to most hedgers),[62] will do nothing to control excessive speculation but will harm legitimate hedgers such as COPE members.

The Position Limits NOPR should be in sync with legitimate hedging activities occurring today. It should recognize the cross-commodity hedges that are used today (such as crude oil for natural gas liquids) and permit them to continue unfettered by limits meant to curb excessive speculation. The Commission should not apply factors such as the quantitative test without an appreciation for market practices or the impact on legitimate hedging. Excessive speculation cannot be controlled by restricting legitimate hedging or imposing complex rules for which compliance and associated processes are opaque and inhibit efficient hedging. The Commission should eliminate the quantitative factor from its proposal.

The Proposed Limits Are Not Adequately Supported

The Commission proposes to establish Spot Month and Non-Spot Month (All Month) limits.[63] Unlike the vacated rule, the Position Limit's NOPR would make all limits effective upon the effectiveness of a final rule.[64] The Commission proposes to set initial spot limits at current DCM levels or, in the alternative, at twenty-five percent of deliverable supply (initially estimated by an

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[59] *Id*. at 75716.

[60] Position Limits NOPR at 75717.

[61] *Id*. at 75828 (proposed § 150.3(e)(1)).

[62] *Id.*

[63] *Id.* at 75826 (proposed §§ 150.2(a) (Spot-month speculative position limits), 150.2(b) (Single-month and all-months-combined speculative position limits).

[64] Position Limits NOPR at 75826 (proposed § 150.2(e)) (limits effective 60 days after publication of final rules in the Federal Register).

exchange and then validated by the Commission).[65] For non-spot month limits, the Commission proposes to use a percentage of open interest (first in futures, options and significant price discovery contracts, and later using data reported by DCMs and SEFs).[66]

While the Commission lays out the mechanics for its proposed limits, it provides only a limited rationale. However, a review of the proposal shows that the size of the limits do not properly reflect the significant jump from exchange limits covering a single contract to overarching limits covering all affected futures, options swaps, and trade options.

Spot Limits

Each of the core referenced futures contracts is currently subject to exchange position limits which correspond to the spot limits proposed in the Position Limits NOPR. Those limits cover that specific contract. For the energy contracts, the core referenced contract will have a "look-alike" version traded on the Intercontinental Exchange ("ICE") that is also covered by a position limit. In addition to the "look-alike" contracts, DMO has published a non-exclusive list of exchange-traded contracts that are also subject to position limits.[67] To this total, the Commission proposes to include all other exchange-traded and over-the-counter swaps and trade options that meet the "Referenced Contract" test.[68]

The Commission has proposed to set the initial spot month limits at the existing DCM-set levels for the core referenced futures contracts ("Existing Spot Limits Proposal").[69] The Commission has also proposed two potential alternatives for setting the initial spot limits: (1) set the initial spot month limits at 25 percent of estimated deliverable supplies under the relevant contracts as submitted to the Commission by the CME Group in correspondence dated July 1, 2013 ("CME Deliverable Supply Spot Limits Alternative"); or (2) set the initial spot limits, in the Commission's discretion, using the recommended level (if any) of the spot month limit as submitted by each DCM listing a core referenced futures contract (if lower than 25 percent of estimated deliverable supply) (the "DCM Deliverable Supply Spot Limits Alternative").[70] Under the Existing Spot Limits Proposal or either of the alternatives, the Commission proposes to set spot month limit levels in the future based on 25 percent of the estimated spot-month deliverable supply in the relevant core referenced futures contract, no less frequently than every two years.[71] The result will be that while the spot limits will be tied to different estimates of deliverable supply change over time, their initial establishment will track the concept underlying the setting of the exchange limit in effect today.[72]

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[65] *Id*. at 75727-28.

[66] *Id*. at 75729-30.

[67] *See infra* footnote 21.

[68] Position Limits NOPR at 75825 (proposed definition of "Referenced contract").

[69] *Id*. at 75727.

[70] *Id*. at 75727-28.

[71] *Id*. at 75728.

[72] *See* 17 C.F.R. § 150.5(b)(1) (Exchange-set speculative position limits) ("For physical delivery contracts, the spot month limit level must be no greater than one-quarter of the estimated spot month deliverable supply.").

Assuming that the current exchange limits are appropriate for a single contract, the significant expansion of the universe of covered contracts must be taken into account when setting limits under a position limits final rule. Today, a person with a position in a core referenced contract in energy products will be subject to an exchange position limit ("CME Limit"). If they also have a position in a look-alike future on ICE, they are also subject to an exchange position limit ("ICE Limit"). Thus, they are subject to the CME Limit **plus** the ICE Limit for the same clearly economically equivalent futures contract. In addition to these two contracts, the person may have positions in contracts identified on the DMO list which are also each subject to individual exchange position limits ("DMO Identified Contracts"). Thus, the limits the limits they face are the CME Limit **plus** the ICE Limit **plus** the limit for each of the DMO Identified Contracts ("Current Total Limit"). While these limits are applied on an individual contract basis, assuming they are economically equivalent as contended by the Commission, it should not matter which contract is held. To this set of contracts, the Commission is proposing to **add** all other referenced contracts including swaps and trade options.

The effect of the Position Limits NOPR is to subject the set of contracts noted above to the CME Limit. This proposal ignores that magnitude of the set of contracts that will now be subject to the limit or the existence of the Current Total Limit.[73] The proposal effectively finds that the current exchange position limit is fundamentally flawed and that the Commission's oversight of such limits has been similarly deficient. Assuming the current exchange-based regime is not fundamentally flawed, extrapolating the single contract limit to the contract scope now to be made subject to the spot month limit appears to be significantly overly restrictive and without justification. The same is true of the alternative proposal as it is rooted in the same basic method of creating the limit.

The scope of the contracts covered should be evaluated in the context of the risk of excessive speculation and a limit for this specific set of contracts should be created. Merely carrying forward a limit (or a similarly derived limit) for a single contract on a single exchange lacks a coherent basis to achieve the desired result. The problem with the Commission's approach is that the exchange limit is related to a price discovery contract (the excessive speculation of which could impact markets) while the proposed aggregate limit is tied to all referenced contracts whether or not they service a price discovery function. It seems clear that contracts that do not serve a price discovery function should not be subjected to the same restrictions as those that do.[74] As the Commission has included both in its proposal, the limits should reflect the difference from the exchange based regime and be increased in recognition thereof.

As stated elsewhere in these comments, COPE believes all contracts that do not serve a price discovery function should be removed from any position limits regime and physical and financial price discovery contracts should be treated differently. Assuming the Commission was to enact such a regime, COPE believes that the CME Deliverable Supply Spot Limits Alternative for the establishment of spot month limits is superior to merely carrying over the CME Limits under the Existing Spot Limits Proposal, assuming the Commission can logically tie the reasonableness of resulting limits to the goal of preventing excessive speculation in the scope of covered contracts.

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[73] Of course on a contract by contract basis, each contract will remain subject to exchange limits.

[74] This concept is implicit in the conditional spot-month limit exemption in which non-price discovery contracts may be subjected to higher limits upon meeting restrictive criteria.

Non-Spot Limits

Non-Spot Month limits are proposed to be based upon open interest data, initially for futures, options and significant price discovery contracts and then upon data from DCMs and SEFs.[75] This proposal reflects the implicit recognition that position limits are only relevant to price discovery contracts. Nevertheless, as noted above, the scope of contracts covered includes all referenced contracts including trade options and over-the-counter swaps. As such and as is true of the Spot Month limits, there is a mismatch between the set of contracts used to establish the limits and the set of contracts covered by the limits. As the proposed limits are a ratio of the open interest in only a subset of the affected contracts, the result (which ignores the totality of the set of contracts covered) is *a limit that is too limited*. Assuming that the Commission was to limit the scope of limits to price discovery contracts, then its proposal would make a logical connection between the data used and the limits imposed.

However, rather than develop a targeted proposal that identifies the excessive speculation in the contracts to be covered and establishes limits in connection with preventing the asserted harm, the Commission has proposed an arbitrary approach. COPE requests that the Commission assure in any final rule that there is a meaningful tie between the limits established; the harm to be prevented taking into account the contracts that have been made subject to the limits. That is, the Commission should make sure (or at least evaluate) that the limits established by its rule are designed to prevent excessive speculation in each of the contract covered by limiting the set of referenced contracts any person can hold. For example, if a person only held trade options and over the counter financial swaps, would the limit properly serve the goal of preventing excessive speculation?

While the foregoing is applicable to both Spot Month and Non-Spot Month limits, it is of particular importance to Non-Spot Month limits because such limits have not previously existed. Further, the Commission has proposed *bona fide* hedges be time limited in some cases making Non-Spot limits virtually absolute. Merely imposing predetermined ratios to an open interest of a subset of affected contracts without providing a sufficient connection to the affected contracts and efficacy of the limits will result in an overbroad rule that can create inefficient economic impacts on markets used by COPE members in their commercial businesses.

In addition, as the Commission has publically stated, it is in a shakedown period for the acquisition and utilization of data other than that provided by DCMs.[76] COPE recommends the Commission delay the implementation of any Non-Spot Month limits until it has been able to move to a level in which it is confident in data acquisition and proficiency. Setting a new, untested position limits regime based upon uncertain data is a bridge too far. The Commission should act carefully and deliberately only when its data issues are resolved before using such data in something as data driven and material as Non-Spot Month limits.

[75] Position Limits NOPR at 75729-30.

[76] *See, e.g., CFTC to Address Data Problems Clouding Swaps Transparency*, Andrew Ackerman, The Wall Street Journal (January 21, 2014), *available at* http://blogs.wsj.com/moneybeat/2014/01/21/cftc-to-address-data-problems-clouding-swaps-transparency/.

The Conditional Spot-Month Limit Exemption Is Not Workable and Must be Revised

The Commission has proposed a "conditional spot-month limit exemption" to spot month position limits wherein such limits

> may be exceeded for cash settled referenced contracts *provided that* such positions do not exceed five times the level of the spot-month limit specified by the Commission and the person holding or controlling such positions does not hold or control positions in spot-month physical delivery referenced contracts.[77]

Thus, the limit for those holding only cash settled futures, options, or swaps can be five times higher than if they held a least one physical delivery contract.

COPE understands the rationale for this conditional exemption to be that cash settled contracts are of unlimited quantity and are not price discovery contracts. This reasoning supports the view that subjecting them to position limits is not a cure for excessive speculation. As proposed by the Commission, each cash-settled contract is apparently 20% as impactful for use in excessive speculation as a physical contract. This logic should cause the Commission to consider the utility of the inclusion of cash settled contracts, particularly uncleared and over-the-counter swaps in position limits.

While the conditional spot-month limit exemption is a positive step in limiting the burden of position limits on commercial hedgers, it creates a real problem. That is, commercial hedgers have historically utilized at least some physical delivery contracts and, due to their commercial needs, will likely be parties to trade options. Thus, the conditional spot-month limit exemption will not be of use to them unless they alter their prudent commercial activities.

Therefore, the Commission should alter its proposal that holding one spot-month physical delivery referenced contract renders a person ineligible to avail herself of the very real rationale underlying the conditional spot-month limit exemption – that cash settled contracts should receive a less restrictive treatment in an final rule. As a result, the Commission should instead provide for physical delivery price discovery contract position limits and separately provide for five times larger position limits for cash settled contracts (or better yet exclude them). In the alternative, the Commission could, as was done the Prior Rule with respect to natural gas,[78] provide for a limit of five times deliverable supply with no more than 20% of the position held being in physical delivery contracts. Of course, as noted above, trade options should be excluded from position limits. If the Commission were to enact the foregoing, it would be better linking the proposal to avoiding the postulated harm of excessive speculation.

The Commission has coupled the use of the conditional spot-month limit exemption with a requirement that that persons claiming a

> conditional spot month limit exemption must report on new Form 504 daily, by 9 a.m. Eastern Time on the next business day, for each day that a person is over the spot month limit in certain special commodity contracts specified by the Commission. The scope of reporting—purchase and sales contracts through the delivery area for the core referenced

[77] Position Limits NOPR at 75830 (proposed § 150.5(b)(5)(ii)(B)) (emphasis in original).

[78] Prior Rule at 71687 (§ 151.4(a)(2)(ii)(B)).

> futures contract and inventory in the delivery area—differs from the scope of reporting for bona fide hedgers…"[79]

Thus, since the higher limit is characterized as an "exception," those under the limit will be required to file a daily form if over the spot month position limit.

The Commission should remove this aspect of its proposal from any final rule. If a separate cash settling limit is created, there will be no need for this form. Further, this form will create the burden for hedgers to track their cash business and affected contracts and create systems enabling them to file multiple forms. The Commission should strive to create a simplified system that the asserted beneficiaries of its regulation can efficiently implement without needless cost and complexity. COPE strongly suggests that the Commission implement any final rule with as few forms and burdens as possible on hedgers. There should be a separate limit for cash settling contracts and no Form 504. In no event should end-user/hedgers be subjected to the daily filing of reports.

The Commission Should Assure Any Required Forms Are The Least Burdensome and Most Clear Possible & Overall Burdens and Costs Are Reduced

The Position Limits NOPR includes a proposal that a suite of forms will be filed by affected persons at various times, with various frequencies, triggered by various circumstances.[80] In general, those not currently subject to federal position limits (such as COPE members) are not required to file any such forms. These forms are not lengthy but they represent a significant data collection and categorization requirement in order for them to be correctly populated.[81] Accordingly, the work required to accurately prepare and file these various forms will not be trivial.

A comprehensive position limits regime could be implemented with a far less burdensome set of filings; (for example, as noted above, Form 504, detailing the composition of the cash positions of each commodity underlying a referenced contract that is held, could be eliminated entirely). COPE requests that the Commission review its proposed forms and ensure that they are as clear, limited, and workable as possible such that burdens can be reduced and the goals sought by the Commission are also met.

Further, COPE requests that the Commission create straightforward, user-friendly guidebooks for the forms it requires to assure that commercial end-user/hedgers as well as the sophisticated CFTC-focused *cognoscenti* can clearly understand and correctly and timely file any required forms. The Commission should also hold workshops to assist in improving the forms and making sure that questions and issues are surfaced and addressed.

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[79] Position Limits NOPR at 75744 (internal citation omitted).

[80] *See id.* at 75788-90 (proposed §§ 19.00(a)(1) (Persons filing for exemption to speculative position limits); 19.00(b) (Manner of reporting); 19.01(b) (Time and place of filing reports).

[81] *See id.* at 75789 (proposed § 19.01(a) (detailing extensive information of stocks and fixed price purchases and sales in connection with reports filed in connection with claiming *bona fide* hedge exemptions).

The Commission Should Address and Correct Other Issues of Burden and Costs to Hedgers in Any Final Rule

The Position Limits NOPR includes other components that should be modified to reduce burdens and costs that would result from its implementation. Examples of such burdens and costs are:

- The Position Limits NOPR requires real-time compliance with limits, including over-the-counter contracts. The logistical compliance challenge of this requirement (which is exacerbated by the proposals in the Aggregation NOPR) should be self-evident; physical companies like the members of COPE are simply not set up or equipped with the personnel, technological capabilities, or resources to track all referenced contract positions across business segments, affiliates and offices in financial and physical contracts in real time to ensure constant compliance with position limits. The Commission could lessen this burden by shifting from a real-time requirement to an end-of–day requirement.
- The Position Limits NOPR limits the pass-through of a *bona fide* hedge to only the counterparty of the hedger.[82] COPE understands that the purpose of the pass-through is to permit such a counterparty to use the hedge to offset exceeding limits. However, when that counterparty acts to flatten its risk (a "Counterparty Offsetting Trade), it cannot pass the *bona fide* hedge through. COPE is concerned that the costs that hedgers may face will be impacted because the Counterparty Offsetting Hedge may be more costly (due to its lack of a pass through feature) and that cost will be borne by the hedger. The Commission could lessen this cost impact by permitting a broader pass-through.

The forgoing examples are only a limited subset of the direct and indirect impacts the proposal will have on end-user hedgers. If the Commission determines it should issue a final rule, it should carefully consider the impact on hedgers and assure that burdens such as those set forth above are eliminated to the degree possible.

Conclusion

As noted above, the proposed position limits regime appears to be the most burdensome and intrusive element of Dodd-Frank regulation affecting end-user/hedgers. Unlike swap dealers, swap execution facilities and other similar persons, end-user/hedges did not make an affirmative decision to get into a CFTC-regulated business with the knowledge of the burdens that would entail. Commercial end-user/hedgers are engaged in physical commercial businesses that require tools to hedge risk. The Commission should recognize this distinction and go out of its way to limit the burden it is imposing. In proposing the rule, the Commission noted that, although the record was mixed concerning the need for and efficacy of position limits, it was "erring on the side of caution" in proposing them.[83] Similarly, the Commission should err on the side of reducing end-user/hedger burden when implementing them.

COPE requests that if the Commission issues a final position limits rule, it target the rule to combat manipulation of price discovery contracts (the purpose articulated in the Position Limits

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[82] *Id.* at 75823 (proposed definition of "Bona fide hedging position" at (2)(ii)(B)).

[83] Position Limits NOPR at 75695.

NOPR) and take steps to simplify the rule to reduce the burden, cost of compliance and possibility of inadvertent violations for end-user/hedgers such as COPE members. Although firms such as COPE members are not the type of entities whose activities are targeted by the proposal, they will bear a significant portion of the burden of compliance. As such, the Commission should make every effort to ameliorate the burden on such persons while still achieving its goals. In doing so, the Commission should recognize that imposition of position limits is only one of the Commission's tools to counter manipulation and only undertake any final rule in a targeted fashion closely tying the regulatory requirements enacted to the harm sought to be prevented.

Respectfully Submitted,

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