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February 10, 2014

Melissa Jurgens
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street NW
Washington, DC 20581

RE: Position Limits for Derivatives, RIN 3038-AD99

Dear Secretary Jurgens,

The American Petroleum Institute ("API"), on behalf of its members, submits the following comments to the notice of proposed rulemaking ("NOPR") issued by the Commodity Futures Trading Commission (the "Commission" or "CFTC") concerning federal position limits for commodity derivative transactions under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act").[1]

API is a national trade association representing more than 580 oil and natural gas companies. API's members range from the largest major oil company to the smallest of independents. They are producers, refiners, suppliers, pipeline operators, and marine transporters, as well as service and supply companies that support all segments of the industry. The core business of API members is delivering affordable energy to their wholesale and retail consumers. API's members transact in physical and financial, exchange-traded and over-the-counter markets primarily to hedge or mitigate commercial risks associated with their core business. API members enter into derivative transactions to facilitate physical transactions and to offset related exposures to price risk in such physical markets. Because API members rely on the integrity of markets under the Commission's jurisdiction, it appreciates the opportunity to comment.

I. INTRODUCTION.

API supports the goals of the Dodd-Frank Act to reduce systemic risk and enhance market integrity in the U.S. financial system. While our members appreciate the Commission's efforts to implement the regulations required by the Dodd-Frank Act in a timely manner, it is

[1] *Position Limits for Derivatives*, Notice of Proposed Rulemaking, 78 Fed. Reg. 75,680 (Dec. 12, 2013) ("Position Limits NOPR" or the "NOPR").

important that the Commission implement tailored regulations that achieve the goals of the Dodd-Frank Act without unnecessarily disrupting the efficient operation of physical commodity and derivatives markets upon which API members rely to hedge risk. API believes that any final rule adopted by the Commission to establish federal position limits should balance the prevention of "excessive speculation" with the preservation of liquidity in the commodity derivatives markets and avoid unnecessarily restraining commercial risk-reducing activities. With this threshold policy concern in mind, API offers the following suggestions, which we discuss in greater length below:

- The CFTC should engage in a rigorous cost-benefit analysis that considers the impact to various market segments before implementing federal position limits.
- The CFTC should not adopt an overly restrictive definition of bona fide hedging.
- The CFTC should permit a market participant to identify and mitigate its risks according to its own business needs and goals. The CFTC should not effectively supplant a market participant's business judgment with its own view of commercial risk.
- The CFTC should grant a bona fide hedging exemption for anticipated merchandising activity.
- The CFTC should not adopt an arbitrary test for allowing cross-commodity hedging exemptions.
- The CFTC should exempt trade options from federal position limits.
- The CFTC should expand the definition of bona fide hedge to include commodity transactions priced as differentials.
- The CFTC should adopt the CME Group's estimated levels of deliverable supply.

As a general matter, API supports the comments submitted by the Commercial Energy Working Group ("CEWG") in this proceeding and believes the CEWG addresses API's concerns in addition to others. API offers the comments herein to echo the CEWG's comments and highlight the specific concerns that are most significant to API.

II. The Implementation of Federal Position Limits Should Not Unnecessarily Harm Energy Commodity Markets.

For energy market participants, the NOPR represents a significant shift from the existing framework in which regulated exchanges have the primary responsibility for implementing, monitoring and enforcing speculative position limits and granting related exemptions. The exchanges have the necessary resources, personnel and infrastructure to monitor positions in the market. API is concerned that the Commission's proposed regulatory framework (i) adopts a "one-size-fits-all" approach to position limits that is based, in large part, on the Commission's existing Part 150 regulations, which are applicable to certain futures contracts for agricultural products, and (ii) unnecessarily establishes overly prescriptive bright line rules.[2]

Energy markets have distinct operational differences from the agricultural markets, which historically have been subject to federal position limits.[3] These differences require consideration by the Commission and any new framework for federal position limits adopted in this proceeding must be specifically tailored to reflect the operational characteristics and risk management practices employed in each of the markets.

In light of the above, API believes that the Commission should not operate on the assumption that a historical paradigm for federal position limits in one commodity market can be readily applied across all commodity markets. Thus, the Commission ought to engage in a cost-benefit analysis that considers the impact to various market segments before implementing a new regulatory framework that unnecessarily harms commercial hedging activity.

The Commission should consider an approach to implementing and monitoring federal position limits that continues to utilize the resources and expertise of the exchanges in respect of energy commodities. API submits a paradigm in which both the exchanges and Commission engage in largely duplicative efforts offers no immediate benefit to the Commission or market participants and possibly constrains liquidity in the markets.

III. The Definition of "Bona Fide Hedging Position" Must Not Be Overly Restrictive.

A. Market Participants Must Be Permitted to Identify and Mitigate Commercial Risks in Accordance with their Own Business Judgment.

The definition of "bona fide hedging position" set forth in proposed CFTC regulation 150.1 requires that a commodity derivative contract be "economically appropriate to the reduction of risk in the conduct and management of a commercial enterprise" (the "economically appropriate test"). API requests that the Commission confirm that this requirement permits each

[2] For example, as discussed below, the NOPR attempts to enumerate positions that would qualify for bona fide hedging treatment and attempts to restrict bona fide hedging treatment to hedges reducing fixed price risk only.

[3] API recognizes that the proposed federal position limits under the NOPR represent significant changes to the agricultural and softs markets, particularly in the context of bona fide hedging, and that all commodity markets, regardless of the underlying commodities are negatively affected by many of the proposals in the NOPR.

market participant to identify risks in connection with its own business judgment and risk management policies. More specifically, this requirement must provide each market participant with the flexibility and discretion to identify and manage its risk as it deems appropriate be it across an entire corporate entity, or by legal entity, desk, book or business unit. Regulation should not constrain any market participant's view of what is economically appropriate in risk management.

Market participants in the energy commodity markets have different hedging goals and objectives and may identify or evaluate risks differently. Energy markets are dynamic and complex and present a variety of factors, such as delivery locations or product grades, which can be considered in achieving risk mitigation goals. Moreover, different commercial firms accept different risks and use a variety of effective business processes to achieve commercial objectives.[4] There are numerous circumstances in which it is economically appropriate to hedge specific risks in isolation or in the aggregate.

The Commission must avoid effectively supplanting a market participant's own judgment with regulations that direct a market participant to take a specific view of what is "economically appropriate" to its own business. The NOPR, in allowing certain positions to qualify for bona fide hedging treatment but not other equally risk-reducing positions, constrains the hedging objectives of commercial entities. This constraint will unnecessarily restrict the energy commodity markets and harm commercial hedging activity. Accordingly, the CFTC should clarify that, so long as a business can reasonably demonstrate that a hedging activity reduces or mitigates one or more specific, identifiable risks related to individual or aggregated positions or transactions, such activity should be deemed "economically appropriate."

B. The CFTC Should Retain Its Current Framework for Granting Bona Fide Hedging Treatment to Non-Enumerated Positions.

The NOPR provides that bona fide hedging exemptions will be granted only to positions enumerated in proposed CFTC regulation 150.1.[5] Unlike existing CFTC regulation 1.3(z), the

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[4] For example, firms may use different approaches on whether supply chain costs might be managed on a fixed-price or floating-price basis.

[5] Specifically, proposed CFTC regulation 150.1 provides, in relevant part:

Hedges of a physical commodity: For a position in commodity derivative contracts in a physical commodity:

(A) Such position:

(i) Represents a substitute for transactions made or to be made, or positions taken or to be taken, at a later time in a physical marketing channel;

(ii) Is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise; and

(iii) Arises from the potential change in the value of –

(I) assets that a person owns, produces, manufactures, processes, or merchandises or anticipates owning, producing, manufacturing, processing or merchandising;

(II) liabilities that a person owns or anticipates incurring; or

NOPR excludes a provision that permits market participants to claim an exemption from applicable position limits for non-enumerated hedging positions. The ability of market participants to use a non-enumerated hedge under CFTC regulation 1.3(z) has worked well for many years. There is no substantive basis to eliminate the existing framework for non-enumerated hedges.

The Commission should preserve the framework for non-enumerated hedging positions that exists under CFTC regulation 1.3(z). As a threshold matter, API submits that, given the dynamic nature of energy commodity markets, the Commission cannot, and should not attempt to, identify and limit bona fide hedging treatment to a list of enumerated positions. While the NOPR allows market participants to receive staff interpretive guidance under CFTC regulation 140.99 or exemptive relief under Commodity Exchange Act ("CEA") Section 4a(a)(7) for positions not enumerated in CFTC regulation 150.1, the proposed framework under CFTC regulation 140.99 and CEA Section 4a(a)(7) for obtaining relief is impracticable and ill equipped to respond as rapidly as is often required by commercial hedgers, resulting in accumulation of costs and lost opportunities.

Given the restrictive nature and narrow definition of the enumerated bona fide hedging positions set forth in proposed CFTC regulation 150.1, there likely will be several petitions or requests seeking bona fide hedging treatment for non-enumerated hedging positions. However, the NOPR, CFTC regulation 140.99, and CEA Section 4a(a)(7) do not set forth specific timelines within which the Commission must deny or grant such petitions or requests. Further, these avenues for seeking bona fide hedging relief do not clarify the type of showing that must be made for a non-enumerated position to qualify for bona fide hedging treatment.

API requests that the Commission retain its framework for non-enumerated hedging positions that currently exists under CFTC regulation 1.3(z) and permit the exchanges to continue administering exemptions for such positions in real time. A non-enumerated hedge category would provide market participants with a real-time ability to hedge, but also would permit such hedging positions to be subject to review and scrutiny should trading activity be questioned by the Commission.

C. The CFTC's Definition of "Bona Fide Hedging Position" Should Include an Exemption for Anticipated Merchandising.

At a minimum, the CFTC must provide an enumerated bona fide hedging position for anticipated merchandising activity. In a distinct departure from vacated CFTC regulation 151.5 and Congressional intent, the NOPR does not allow anticipated merchandising positions to qualify as bona fide hedging positions. The Commission reasons in the NOPR that where a

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(III) services that a person provides, purchases, or anticipates providing or purchasing; ***and***

(iv) ***Is enumerated in paragraph (3) [(Enumerated hedging positions), (4) [(Other enumerated hedging positions)] or (5) [(Cross-commodity hedges)] of this definition . . . .***

(emphasis added).

merchant anticipates purchasing or selling a commodity without having acquired inventory or fixed-price purchase or sale contracts, price risk has yet to be assumed, and therefore, a commodity derivative contract would not reduce this "yet-to-be-assumed" risk.[6] This view reflects a very narrow perspective of risk. Such a view is contrary to sound and customary risk management and the plain language of the statute, and ultimately lessens the ability of commercial firms to hedge.

Merchandising is critical to the physical supply chain from the production to the consumption of commodities. API members hold real and significant price risk associated with their merchandising positions even before the underlying physical purchase or sale is finalized. The ability of commercial firms to hedge foreseeable risks is often a necessary condition to entering into the physical transaction.

It is doubtful that Congress intended to marginalize merchandising activity or treat differently the hedges related to producing, processing and consuming on one hand and anticipated merchandising on the other.[7] In fact, a plain reading of the CEA would suggest the opposite—that Congress intended hedges placed for anticipated merchandising to qualify for bona fide hedging treatment. API submits that the economically appropriate test does not require the Commission to establish a bright line interpretation or requirement that a market participant have fixed-price risk to qualify for bona fide hedging treatment. Therefore, the Commission should adopt a provision in its enumerated bona fide hedging definition that would allow anticipated merchandising positions to be given bona fide hedging treatment.

IV. Cross-Commodity Hedging.

Proposed CFTC regulation 150.1 would provide a cross-commodity hedging position an exemption from speculative position limits if the "fluctuations in value of the position for future delivery are substantially related to fluctuations in value of the actual or anticipated cash positions." The NOPR, however, establishes a safe harbor for cross-commodity positions wherein the correlation between the daily spot price series for the target commodity and the price series for the commodity underlying the derivative contract is at least .80 for at least 36 months (the "safe harbor"). Without any empirical data, API is uncertain how the Commission

[6] NOPR at 75,718

[7] CEA Section 4a(c)(2) provides:

> For the purposes of implementation of subsection (a)(2) for contracts of sale for future delivery or options on the contracts or commodities, the Commission shall define what constitutes a bona fide hedging transaction or position as a transaction or position that-
>
> . . .
>
> (iii) arises from the potential change in the value of–
>
> (I) assets that a person owns, produces, manufactures, processes, or ***merchandises*** or ***anticipates*** owning, producing, manufacturing, processing, or ***merchandising***;
>
> (emphasis added).

established its .80 correlation factor. API believes that this safe harbor is arbitrary and inconsistent with risk management practices utilized in the crude oil and other energy commodity markets. Moreover, the safe harbor (i) addresses economic relationships for cross-commodity hedging between spot market prices even though cross-commodity hedging typically occurs outside the spot month, (ii) applies an inappropriate look-back period, and (iii) sets a correlation factor that is too high, disqualifying hedges that legitimately reduce risk.

Accordingly, the Commission should adopt a facts and circumstances test to determine whether a cross-commodity position should be granted hedging treatment. There are derivative positions that represent a correlation less than .80 that are risk-reducing and reflect the most appropriate hedge available. A market participant engaging in legitimate hedging activity will ordinarily prefer the correlation between the hedging instrument and the underlying exposure to be as high as possible. However, in the absence of highly correlated instruments, firms might feel it prudent to hedge risk with an instrument with a moderate correlation with the underlying exposure, particularly if the alternative is not to hedge at all.

The Commission should not apply its five-day rule to cross-commodity hedging positions. If the Commission retains this restriction, market participants who own stocks of physical products that are hedged on a cross-commodity basis using physical-delivery Referenced Contracts will have to remain completely exposed to price risk during the spot month or replace their hedges with less effective hedges. The petroleum industry, in particular, would be impacted given the large number of varying crude grades and types of refined products involved. Ultimately, it must be recognized that these positions are not speculative in nature and, thus, should not be subject to speculative position limits.

V. THE COMMISSION SHOULD EXEMPT TRADE OPTIONS FROM POSITION LIMITS.

Physical forward contracts with embedded volumetric optionality are prevalent in crude oil and other energy commodity markets. API members enter into such transactions to meet their supply chain needs and manage risk.[8] More specifically, physical forward contracts with embedded volumetric optionality allow API members, at the time of execution, to ensure the supply of a physical commodity in unexpected circumstances, such as an increase in demand or a supply source becoming unavailable. The NOPR must consider the operational and risk-reducing benefits these contracts provide to market participants.

If trade options were subject to federal position limits, it would lessen the ability of commercial firms to use the futures and swaps markets to meet their physical supply or sale needs because the futures equivalent of the trade options would be applied when determining if a firm holds a position below the limit. In some instances, market participants *with no* derivatives positions other than trade options could find themselves in violation of position limits. Ultimately, the Commission has not proffered sufficient justification for subjecting trade options to federal position limits.

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[8] It's important to note here that volumetric options are more likely to be managing *volume* risk, rather than *price* risk.

API is concerned that trade options would not meet the definition of "bona fide hedging position." Proposed CFTC regulation 150.1 requires a commodity derivative contract to "represent a substitute for transactions made or to be made, or positions taken or to be taken, at a later time in a physical marketing channel." However, because some trade options function as pure physical purchases or sales, it is unclear whether such transactions would be considered the substitute, or the actual, position taken in the physical marketing channel and meet this prong of the bona fide hedging definition.

Additionally, several of the enumerated bona fide hedging positions would not allow a market participant to carry a physically-delivered Referenced Contract (*e.g.*, a trade option) into the spot month. Given many trade options require physical delivery during or after the spot month, market participants would not receive bona fide hedging treatment for such positions.[9] Thus, those market participants would have to abandon their trade options even though they may be the right instrument to manage their supply chain needs.

In light of the above, the Commission must exempt trade options from federal position limits. Subjecting these products to federal position limits will unnecessarily reduce liquidity and harm the efficient operation of physical commodity markets.

VI. The Commission Should Expand the Definition of Bona Fide Hedge to Include Commodity Transactions Priced as Differentials.

The CEWG describes in their comment several types of hedging where prices of physical commodities are set on a differential from a core reference contract or mitigate risks associated with pricing differentials between different grades of the same or similar commodities. These exposures are real and a market participant's ability to hedge them is critical. The types of hedging described by the CEWG are not unusual in the petroleum industry, and are significant to members of API. Accordingly, to the extent the Commission elects to adopt enumerated bona-fide hedge categories, API recommends that it provide a category for transactions that hedge a differential between locations, grades or qualities of two or more commodities.

VII. Conclusion.

For the reasons described in these comments, API is concerned that the NOPR is too restrictive and could impair market liquidity in the energy commodity markets. In implementing final rules establishing federal position limits, the Commission should seek to curb excessive speculation while preserving liquidity in the derivatives markets that API members rely on to hedge their physical risk.

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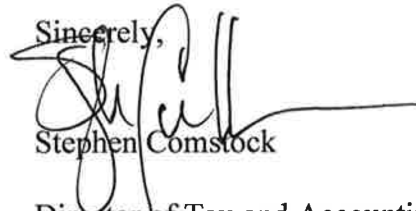
[9] Market participants holding trade options also would not qualify for the conditional spot month exemption for cash-settled Referenced Contracts as the exemption requires market participants to hold no physically-delivered Referenced Contracts.

API appreciates the opportunity to provide these comments. API members are pleased to provide any additional information regarding their views on the NOPR and welcome the opportunity to work with the Commission as it develops its final rule.

Should you have any questions or concerns regarding this comment, please direct them to Stephen Comstock at (202) 682-8455 or comstocks@api.org.

Sincerely,



Stephen Comstock

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