February 10, 2013

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

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

Re: Position Limits for Derivatives (RIN 3038-AD99)

Dear Ms. Jurgens:

Citadel LLC[1] ("Citadel") appreciates the opportunity to provide comments to the Commodity Futures Trading Commission (the "Commission") on its notice of proposed rulemaking on *Position Limits for Derivatives* (the "Proposed Rule").[2] We have strong reservations about the necessity, efficacy, and unintended consequences of the proposed position limits, and believe that revisions to the Commission's proposal are required in order to appropriately balance the statutory goals of checking *excessive* speculation and deterring manipulation while nevertheless preserving liquidity and safeguarding the price discovery process.[3]

Investors play an essential and beneficial role in the commodities markets. Investors' research and analysis leads to greater transparency, facilitating more efficient economic decisions by commodity producers and consumers and optimizing resource allocation across the real

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[1] Established in 1990, Citadel is a leading global financial institution that provides asset management and capital markets services. With over 1,100 employees globally, Citadel serves a diversified client base through its offices in the world's major financial centers including Chicago, New York, London, Hong Kong, San Francisco and Boston.

[2] Position Limits for Derivatives, 78 Fed. Reg. 75,680 (proposed Dec. 12, 2013), *available at* http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2013-27200a.pdf.

[3] Section 4a(a)(1) of the Commodity Exchange Act states that any position limits must achieve the following four statutory goals: (i) to diminish, eliminate, or prevent excessive speculation; (ii) to deter and prevent market manipulation, squeezes, and corners; (iii) to ensure sufficient market liquidity for bona fide hedgers; and (iv) to ensure that the price discovery function of the underlying market is not disrupted. 7 U.S.C. § 6a(a)(1).

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economy. At the same time, investors' market activity enhances liquidity and facilitates the price discovery process for all market participants.

Commodity market investors analyze troves of data and conduct detailed modeling of market trends and dynamics to guide their trading activity. By bringing their informed investment decisions to the marketplace, investors make the commodity markets more liquid and their pricing function more efficient. Among other benefits, this helps normalize the prices of commodity futures at different maturities and dampens price volatility. Collectively, these market efficiencies not only enable commodity producers and consumers to manage their risks, but also inform their forward capital investment and resource allocation decisions. Efficient commodity markets optimize economic output by informing the business decisions of farmers planting crops or energy producers drilling new wells, among others.

Investors are also critical to commodity market liquidity and the price discovery process. Commodity producers and direct consumers of those commodities only "meet" directly, if at all, by chance given the different sizes, durations, and specifications of their risk management needs, and the size of the marketplace. Instead, investors, market makers and others provide needed liquidity to enable producers and consumers to achieve their commercial goals. The availability of investor capital to take both long and short positions, bring in new information, and express countervailing views, creates deep, liquid and efficient markets.

We fear that limiting the role investors can play in the commodity markets through the imposition of position limits will reduce liquidity and create greater price opacity. It will likely also result in the availability of fewer and more expensive risk management solutions for producers and consumers offered by remaining liquidity providers who extract greater economic rents for performing such functions.

Given the importance of investors to both commodity market liquidity and price discovery, with respect to the Proposed Rules, we believe that:

I. The Commission has not made an adequate necessity finding, as required, for the proposed position limits

II. Any position limits should be based on complete, accurate and current data

III. Position limits for cash-settled contracts are not warranted

IV. Position limits for contracts outside of the spot month are not warranted

V. Cross-commodity netting should be permitted

VI. Calendar spread netting should be permitted

VII. Commodity index swaps should not be treated differently than other cash-settled contracts

VIII. The disparate treatment of different types of market participants, otherwise engaged in similar forms of trading activity, is not justified

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I. The Commission has not made an adequate necessity finding, as required, for the proposed position limits

The Commission asserts errantly that it is not required to make a "necessity" finding prior to establishing position limits, yet simultaneously proffers a necessity finding that is neither adequate nor fit-for-purpose.

The Dodd-Frank Act did not relieve the Commission of its obligation to make a necessity finding prior to establishing position limits. Rather, our plain reading of the statute is that, by inserting the "as appropriate" standard in Section 737 of the Dodd-Frank Act, Congress did not change the requirements the Commission must satisfy prior to exercising its authority to establish position limits. Specifically, this language is consistent with existing Commodity Exchange Act standards that position limits be set "as the Commission finds are necessary…"[4] Furthermore, we question the Commission's conclusion that two staff reports from the Permanent Subcommittee on Investigations in 2005 and 2006 are broadly indicative of Congressional intent in this matter,[5] or that they redefine statutory language that has existed for nearly eight decades. We therefore believe that a necessity finding is indeed required prior to the Commission's establishment of any position limits. Our belief is supported by the D.C. District Court's finding that Section 4a(a)(1) of the Commodity Exchange Act "unambiguously requires that, prior to imposing position limits, the Commission find that position limits are necessary to 'diminish, eliminate, or prevent' the burden described in Section [4a(a)(1)]."[6]

The necessity finding then proffered by the Commission – which consists of a discussion of two historical events and a cursory review of existing studies and reports on position limits related

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[4] Section 4a(a)(1) of the Commodity Exchange Act; 7 U.S.C. § 6a(a)(1).

[5] Proposed Rule at 75682.

[6] International Swaps and Derivatives Association v. U.S. Commodity Futures Trading Commission, 887 F.Supp.2d 259, 270 (D.D.C. 2012).

issues – falls short of a comprehensive analysis and justification for the proposed position limits.[7] By contrast, we believe that an adequate necessity finding should be informed by current market data, be germane to a specific commodity market, and provide explicit justification for any proposed position limits.

The invocation of select past events ignores the composition and dynamics of today's markets, is of limited relevance to policy proposals outside of the spot month, and provides too narrow a basis on which to extrapolate policy prescriptions across all commodity markets. Further, citing these historical cases overlooks other tools now available to address such behavior, including, for example, enhanced market surveillance, broadened reporting requirements, broadened special call authorities, and exchange limits.

Meanwhile, the 132 studies and reports cited by the Commission in Appendix A cover an array of disparate topics and are not necessarily germane to specific position limits being proposed.[8] The Commission itself notes that "these studies overall show a lack of consensus regarding the impact of speculation on commodity markets and the effectiveness of position limits," but then proceeds to cherry-pick among them by summarily dismissing those studies that "militate against imposing any speculative position limits" by claiming that they conflict with the Commission's interpretation of Congressional intent.[9]

II. Any position limits should be based on complete, accurate and current data

As a threshold matter, we believe the Commission should ensure that it has complete, accurate and current data on which to base position limits *before* it makes a necessity finding or finalizes and imposes any such limits. At this time, however, it appears there are a number of deficiencies and omissions in the data the Commission is proposing to rely on. Given that the proposed position limits are calculated as a percentage of deliverable supply and open interest data, it is irresponsible to proceed with any limits on legitimate market activity that are based on incorrect or incomplete information. We are extremely concerned that the data the Commission proposes to rely on could dramatically understate the true trading activity that is occurring in a number of commodity markets, yielding artificially low limits, particularly given the lack of inclusion of large parts of the OTC swaps market. We thus encourage the Commission to resolve these data issues to better inform and calibrate any position limits it establishes. Specifically, we

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[7] Proposed Rule at 75685-75694.

[8] Many of the studies, for example, focus on the role of commodity index funds, which are not subject to the proposed position limits. Others evaluate the positive or negative impact of speculation in a variety of commodity markets, from oil to natural gas to food. While some of these studies analyze the pros and cons of speculative position limits, it appears to us that few, if any, specifically examine the relevance of position limits outside of the spot month even though non-spot month limits are a significant component of the Proposed Rule.

[9] Proposed Rule at FR 75695.

are concerned by the following aspects of the data to be referenced:

- Data being reported to SDRs does not yet provide a complete and accurate picture of swap market activity,[10] a prerequisite to calculating any position limits based on open interest.
- Data from the Commission's large trader reporting is not yet reliable enough or suitable for setting position limits.[11]
- The proposed calculation of open interest excludes material segments of market activity. For example, trading in index swaps, which is substantial, is not factored in at all.
- The estimated deliverable supply figures the Commission is proposing to rely on for spot month position limits are up to 20 years old, notwithstanding CME's submission of current figures.[12]
- Notwithstanding the fact that position limits will apply across both the futures and swaps markets, the Commission is proposing to initially base its limits on exchange open interest only, ignoring the sizeable relevant activity in the uncleared swaps market.[13]

III. Position limits for cash-settled contracts are not warranted

The imposition of position limits on cash-settled contracts will unnecessarily constrain liquidity in otherwise important markets, with no clear countervailing benefit. While cash-settled contracts are priced or settled based on a reference to the physical market, it is unclear to us how cash-settled contracts could influence, let alone distort, the price of a physically-settled contract (nor are the two fungible). Therefore, the utility of position limits on cash-settled contracts – with respect to either checking excessive speculation or deterring manipulation – appears limited.

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[10] As noted by Under Secretary for Domestic Finance Mary Miller, "The data are fragmented, with many different trade repositories, within and across jurisdictions, collecting different kinds information in different ways, keeping us from putting all that information together to develop a full picture of the market." Mary Miller, Under Secretary for Domestic Finance, U.S. Dept. of the Treasury, Remarks to the Office of Financial Research and the Financial Stability Oversight Council conference on Mapping and Monitoring the Financial System: Liquidity, Funding, and Plumbing (Jan. 23, 2014), *available at* http://www.treasury.gov/press-center/press-releases/Pages/jl2262.aspx.

[11] Commissioner O'Malia noted "It is especially troubling that the large trader data being reported under Part 20 of Commission regulations is still unreliable and unsuitable for setting position limit levels, almost two full years after entities began reporting data, and that we are forced to resort to using data from 2011 and 2012 as a poor and inexact substitute." Proposed Rule at FR 75841.

[12] Proposed Rule at FR 75727.

[13] *See, e.g.,* Proposed Rule at 75730.

The supply of cash-settled contracts is, in principle, unlimited, as the supply is not limited by the amount of a given physical commodity that can be delivered at a given point in time. Given this unlimited supply, the potential circumstances that position limits are intended to address – such as market imbalances and price distortions around the time of delivery – do not manifest themselves in the market for cash-settled contracts. Meanwhile, imposing position limits on cash-settled contracts would curtail liquidity provision in what are otherwise useful markets for a wide array of market participants, including farmers, manufacturers, and refiners. Therefore, to the extent the Commission does make an appropriate necessity finding and then establish position limits, we urge the Commission to restrict such position limits to physically-settled contracts exclusively.

IV. Position limits for contracts outside of the spot month are not warranted

We similarly question the utility of non-spot month position limits – embodied in the proposed single non-spot month limits and the all-months combined limits – and recommend that the Commission consider alternatives to monitor market participants' positions outside of the spot month.

The demand for consumers and producers to hedge prices well into the future is real, and therefore, limiting the ability for market intermediaries and investors to accommodate this demand in non-spot months is not warranted. The Commission has not provided evidence that speculation in the non-spot months poses a risk, and we do not see the potential for manipulative activity outside the spot month. In any event, were a market participant to obtain a large non-spot month position and hold it into the spot month, it would then be subject to the spot month limits.

As an alternative, we urge the Commission to leverage other tools at its disposal to monitor activity outside of the spot month.[14] Using these tools, the Commission could achieve greater transparency into forward-dated activity in a given contract, compared to fixed non-spot month limits. We are concerned that fixed non-spot month limits would serve to cap exposure in that contract, and potentially send interested market participants elsewhere to satisfy their risk transfer needs.[15]

[14] Examples of such tools include its "special call" and large trader reporting authorities, and the Commission can leverage the oversight and powers of trading venues and clearinghouses, to identify and counter any excessive speculation.

[15] Driving legitimate supply and demand to other commodity products or markets harms liquidity, risks increasing volatility, and could lead to pricing dynamics unrelated to market fundamentals.

V. Cross-commodity netting should be permitted[16]

The Proposed Rules sensibly recognize offsets between highly correlated commodities, but then only allow such offsets to be recognized by market participants that qualify for a bona fide hedge exemption. We do not believe that this disparate treatment is warranted, and recommend that cross-commodity *netting* be permitted for all market participants. Further, to the extent the Commission does proceed with non-spot month position limits, but permits cross-commodity netting for all market participants, the quantitative test used to assess whether cross-commodity netting is permissible across non-spot months should be based on the correlation of the respective forward months being traded in each cross-commodity pair.[17]

Given that highly correlated commodities are often used to hedge each other, and that such hedge positions exhibit far less directional market risk exposure than equivalently sized outright positions, permitting cross-commodity netting would not only reflect how market participants actually manage risk, but also would more accurately account for market participants' true risk positions and ability to affect the market. Further, if cross-commodity netting is only allowed for market participants that qualify for the bona fide hedge exemption, it will concentrate cross-commodity risk exposures in a narrower universe of market participants.

Cross-commodity netting would also ameliorate what we believe to be mis-sized and unbalanced position limits across otherwise economically-related commodity contracts, as illustrated in the following two examples.

Crude Oil vs. Oil Products

In the US, approximately 30% of all Crude Oil is refined into Diesel and approximately 50% is refined into Gasoline blending components. However, the proposed non-spot month position limits for Crude Oil (CL), Diesel (HO), and Gasoline (RB) contracts do not reflect this relationship. As a result, the HO and RB limits are far too low. This is problematic given that market participants predominantly trade the HO and RB contracts to hedge their actual fuel usage.

The non-spot month limit for the CL contract is 109,200.[18] Using the 30% and 50% usage ratios cited above, the implied non-spot month limits would be 32,760 for the HO contract and 54,600 for RB contract. However, the proposed non-spot month limit for the HO contract is only

[16] For example, netting should be permitted for all market participants between crude oil and oil products (e.g., gasoline vs. WTI) and wheat at different delivery points (e.g., Kansas City wheat vs. Chicago wheat).

[17] By contrast, the Proposed Rule suggests that *spot* price series must always be a factor in such correlation tests. *See* Proposed Rule at FR 75717.

[18] Proposed Rule at FR 75840.

16,100 (vs. 32,760 implied) and is only 11,800 for the RB contract (vs. 54,600 implied). The Proposed Rule's position limits are far lower than the more realistic non-spot month position limits that are derived based on the usage ratios for US crude oil and oil products. We fear that these unnecessarily low limits will hamper legitimate hedging activity. The limits should be raised, and in addition, the Commission should recognize cross-commodity netting for all market participants across crude oil and oil products to facilitate adequate liquidity provision.

Wheat Market

There is roughly twice as much wheat produced for physical delivery under the Kansas City Wheat contract (KW) as is produced for physical delivery under the Chicago Wheat contract (W). However, there is much more trading liquidity in Chicago Wheat than in Kansas City Wheat.

Therefore, a commercial market participant that wants to hedge a physical supply of Kansas City Wheat will often do so with a Chicago Wheat contract, given the superior liquidity and notwithstanding the fact that the two wheat contracts have different quality and delivery specifications. When this happens, another market participant needs to step in to provide liquidity by taking a position between the Kansas City Wheat and Chicago Wheat contracts. If the proposed position limits unduly constrain trading activity in the Kansas City Wheat contract, then investors will not be able to provide such liquidity.

We fear that as proposed, the 6,500 non-spot month position limit for Kansas City Wheat contracts (vs. the 16,200 non-spot month position limit for the Chicago Wheat contract) would curtail this liquidity provision.[19] This could dramatically impact the Kansas City Wheat market, which is already less liquid than the Chicago Wheat market. Therefore, we believe that the position limits on Kansas City Wheat need to be larger to both promote growth in that market, and to enable liquidity provision across the Chicago Wheat and Kansas City Wheat contracts to account for the way Kansas City Wheat hedgers often use the Chicago Wheat market. In addition, the Commission should recognize cross-commodity netting in wheat for all market participants to facilitate this activity.

VI. Calendar spread netting should be permitted

To the extent the Commission does proceed with non-spot month position limits, we believe that it is essential that the Commission fully embrace, rather than place any limits on, calendar spread netting. As noted previously, the need to hedge prices well into the future is real, especially for natural gas producers, heating oil consumers, oil refiners, and other types of consumers and producers. Investors are able to responsibly and effectively accommodate this

[19] Proposed Rule at FR 75839.

demand by providing liquidity in longer dated contracts by hedging their exposure with shorter dated contracts.

Time spreads, or "calendar spreads," are also critical to real economic activity. For example, in order to finance the drilling of a well, a natural gas producer may choose to sell contracts for future delivery into the market. Meanwhile, the market risk of a calendar spread position is a fraction of the market risk of an equivalently sized outright single month position, and therefore, has far less potential to ever disrupt the market. Therefore, it is counterintuitive that the non-spot month position limits would apply equally to an outright position and a calendar spread position. Curtailing calendar spread activity through the imposition of position limits will thus hurt liquidity without delivering any benefits. Instead, the Commission should recognize netting within calendar spreads as part of any non-spot month position limits the Commission establishes.

VII. Commodity index swaps should not be treated differently than other cash-settled contracts

The Commission excludes commodity index swaps from its proposed position limits. While we believe *all* cash-settled contracts – including index swaps – should be excluded from positions limits, if the Commission proceeds with position limits on cash-settled contracts, it should do so consistently across relevant products, including index swaps.

In some commodity markets, index swap activity drives a material percentage of the market turnover. Nevertheless, positions from commodity index swaps are excluded from the Commission's proposed position limits, notwithstanding the fact that index swaps can be used to run speculative trading books. In fact, individual investors, via index swaps, currently carry positions that are larger than the speculative position limits being proposed in a number of the covered markets.

We fear that the disparate treatment of commodity index swaps will yield a number of unintended consequences under the proposed position limit regime, including:

- Shifting more trading activity into index swaps
- Draining liquidity from exchange-listed products
- Harming pre-trade transparency and the price discovery process
- Further depressing open interest (as volumes shift to index swap positions that do not count towards open interest calculations)

VIII. The disparate treatment of different types of market participants, otherwise engaged in similar forms of trading activity, is not justified

To the extent that the Commission does makes an appropriate necessity finding and then proceed with establishing any speculative position limits, it is imperative that the limits apply equally to the *speculative* activity of all market participants, and do not discriminate among them. We fear that the Proposed Rule would allow certain market participants to continue to engage in material amounts of *speculative* activity in excess of limits applied to certain other market participants. We believe this does not create a level playing field, introduces market distortions, and compromises market efficiency.

We appreciate that the Commission has taken great care to appropriately tailor the bona fide hedge exemption, including by outlining 14 "fact patterns" describing situations where the exemption would apply to ensure its use is confined to true hedging activity. We encourage the Commission to similarly outline situations where the exemption *would not* apply (in addition to situations where it *would* apply).[20] Such examples could further ensure that certain purely *speculative* activities are not conducted under the auspices of the bona fide hedge exemption.

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In conclusion, we believe that the Commission and the markets will be best served by a more deliberative approach to establishing position limits, whereby the Commission first collects reliable data, then makes informed necessity findings on the back of that data, and lastly focuses position limits on physically-settled contracts in the spot month. To the extent the Commission nevertheless proceeds with a broader approach, in order to preserve liquidity and efficient price discovery, it is imperative that netting be recognized across (i) highly-correlated commodities and (ii) different months in the same commodity. Finally, fair and efficient markets require that similar economic activity be subject to the same rules – therefore, all market participants engaging in similar economic activity should be governed equally by any limits the Commission imposes.

We appreciate the opportunity to provide comments on the Proposed Rule. Please feel free to call the undersigned at (312) 395-3100 with any questions regarding these comments.

Respectfully,

/s/ Adam C. Cooper
Senior Managing Director and Chief Legal Officer

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[20] For example, it is unclear if a market participant could use either a deferred cash position or a directional subset of its overall net physical position to qualify for the bona fide hedge exemption.