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February 10, 2014

VIA ON-LINE SUBMISSION

Ms. Melissa Jurgens
Office of the Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Re: Position Limits for Derivatives (RIN No. 3038-AD99); 78 Fed. Reg. 75,680 (Dec. 12, 2013)

Dear Ms. Jurgens:

CME Group Inc. ("CME Group")[1] respectfully submits these comments in response to the Commodity Futures Trading Commission's ("Commission" or "CFTC") "Position Limits for Derivatives," Notice of Proposed Rulemaking ("Proposal"). The Proposal would establish new speculative position limits for physical commodity futures and swaps as well as new hedge and position aggregation standards and rules that would be used to enforce these limits.

CME Group shares the CFTC's regulatory mission of ensuring liquid, fair and financially secure markets. CME Group also appreciates the challenges the Commission faces in adopting and implementing any necessary and appropriate rules for the previously unregulated swaps markets and, in particular, the challenges presented in applying position limits across sometimes vastly different markets and execution venues. Despite our appreciation of the Commission's work, we cannot support the Proposal's position limit framework because of its detrimental effects on hedgers and other market participants we serve and our markets themselves. The Proposal also fails to meet safeguards embedded in section 4a of the Commodity Exchange Act ("CEA" or the "Act") as well as basic tenets of the Administrative Procedure Act ("APA").
Because of these flaws, we believe the Proposal's requirements would result in consequences that are inconsistent with the public interest purposes of section 4a of the Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or "Dodd-Frank Act").

[1] CME Group is the holding company for four separate Exchanges, including the Chicago Mercantile Exchange Inc. ("CME"), the Board of Trade of the City of Chicago, Inc. ("CBOT"), the New York Mercantile Exchange, Inc. ("NYMEX"), and the Commodity Exchange, Inc. ("COMEX") (collectively, the "CME Group Exchanges" or "Exchanges"). CME Clearing is one of the largest central counterparty clearing services in the world; it provides clearing and settlement services for exchange-traded contracts and over-the-counter ("OTC") derivatives contracts through CME ClearPort®. The CME ClearPort® service mitigates counterparty credit risks, provides transparency to OTC transactions, and brings to bear the exchanges' market surveillance monitoring tools.

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We urge the Commission to withdraw the Proposal and engage the exchanges and market participants in a collaborative effort to draft appropriate regulations establishing appropriate aggregate position limits for futures and swaps as necessary. At a minimum, such regulations must establish a framework that, unlike the current Proposal, promotes the public interest purposes of CEA section 4a—to prevent and deter excessive speculation and manipulation while ensuring sufficient liquidity for bona fide hedgers, and protecting price discovery in the underlying benchmark futures contract.

Executive Summary

For many years, CME Group has supported and imposed speculative position limits for physical commodity contracts in the spot months based on a formula grounded in CFTC-accepted estimates of deliverable supply. At the same time, CME Group has supported and imposed appropriate position limits or accountability levels outside the spot month in these contracts. Together, the position limits and accountability levels we have adopted and implemented have effectively served to prevent price manipulation and price distortions while promoting liquid markets that serve the hedging and price discovery needs of commercial end-users. Our systems have work well to protect the public interest, especially when combined with long-standing federal limits for agricultural commodities and sensible CFTC policies distinguishing hedgers from speculators and aggregating positions of those that control trading decisions.

Without citing any deficiencies in the current position limit structure or offering mere perfecting changes to that structure, the Proposal would dismantle that structure. The bulk of the Proposal is ill-conceived as a matter of law and ill-advised as a matter of regulatory policy. In this letter, we consider and discuss the Proposal's deficiencies. Our responses are many because the Proposal consumes 162, three columned Federal Register pages and its scope is vast. For ease of reference, we have summarized our letter here.

The Proposal begins with a CFTC statutory interpretation finding that Congress mandated the imposition of physical commodity position limits even if unnecessary to prevent the supposed burdens associated with excessive speculation. When considered closely, the Proposal does not cite any evidence that Congress intended to mandate the CFTC to impose limits that the CFTC believed to be unnecessary. The law is clear that, since 1936, position limits for a commodity contract could not be imposed unless the regulator found them to be "necessary."[2] In Dodd-Frank, Congress did not amend that statutory requirement. Absent evidence of unambiguous congressional intent to repeal by implication that longstanding "necessary" finding requirement as it relates to physical commodity derivatives, the requirement still stands.[3] The Proposal's interpretation of a position limits mandate should be rejected as we discuss in section I.A. of this letter.

Next, the Proposal contains a "necessary" finding just in case the Congressional mandate to impose unnecessary limits is found to be illusory. As described in section I.C. of this letter, the Proposal's

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[2] CEA section 4a(a)(1); 7 U.S.C. § 6a(a)(1).

[3] *See Hunter v. FERC*, 711 F.3d 155, 160 (D.C. Cir. 2013).

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"necessary" finding suffers from two defects. First, it does not contain any form of particularized by commodity analysis of the need for limits; instead it treats contracts in, among others, crude oil, soybeans, and silver markets exactly alike—an approach that is inconsistent with the statute and sound policy given these markets' appreciable differences. Second, it relies on historical episodes with dubious relevance to the Proposal's recommended framework or market policy in a post-Dodd-Frank world. The Proposal's "necessary" finding offers no reasoned basis for adopting its framework and the shift in regulatory policy it embodies. Moreover, even if position limits can be shown to be necessary, under the CEA the Proposal's requirements may be adopted only if "appropriate" in certain specified respects for contracts linked to the 28 physical commodities referenced by the rulemaking.[4] Throughout this letter, we explain the Proposal's failure to satisfy the "appropriateness" standard.

The Proposal then proceeds to address spot-month and non-spot-month limits. For spot-month limits, the Commission Proposes two different formulas based on deliverable supply—one for physically-delivered contracts (25% of deliverable supply) and one for cash-settled contracts (125% of deliverable supply). The Proposal's first problem is that it relies on deliverable supply estimates that are out of date, in some cases by decades. CME Group submitted accurate and current deliverable supply estimates to the Commission, but the Commission has thus far refused to accept them (although it has asked for comment on them). Commentators thus are uncertain as to what the proposed spot-month limits could be, a basic APA defect in this rulemaking's notice and comment process. The simple fact that the Proposal contains a limit based on 1983 silver and gold, and 1996 natural gas, deliverable supply estimates illustrates that the Proposal does not reflect an appropriate framework for modern markets..

The Proposal's second problem with respect to spot-month limits is related and just as serious due, at least in part, to the sensitive nature of spot-month limits. Those limits historically have been set to promote price convergence and to prevent delivery month price distortions. Yet the Proposal would allow traders to amass positions in cash-settled contracts up to five times the limit for positions in physically-delivered contracts (125% of deliverable supply) so long as the trader holds no position in the physically-delivered contract (including an option on that contract). As a result, a trader could hold a five-times-the-limit cash-settled futures and swap position in a commodity as well as <u>unlimited</u> physical supply of the underlying commodity. The potential price effect of such holdings is staggering and could lead to price distortions or worse in the physically-delivered contract through arbitrage or other normal trading practices.

Notably, the five times limit element of the Proposal would apply to all referenced physical commodity markets without the benefit of analysis of any disclosed data or evidence other than an incorporated by reference slice of natural gas trading data from almost three years ago. The Proposal claims to have examined other data, but it has not disclosed that data to commentators, a basic APA violation. At this juncture, we would recommend that the Commission fix its spot-month proposal by first accepting deliverable supply estimates for each of the 28 referenced physical commodities and then re-proposing spot-month limits for physically-delivered and cash-settle contracts at parity for all commodities, as has been the regulatory rule, not the exception.

[4] *See* CEA section 4a(a)(2) & 4a(a)(3)(B); 7 U.S.C. §§ 6a(a)(2) & 6a(a)(3)(B).

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In addition to the proposed adoption of artificially low spot-month position limits based on outdated deliverable supply estimates and the proposed five times spot-month limit that favors cash-settled contracts to the detriment of physical-delivery contracts, CME Group is deeply concerned by other requirements in the Proposal that target physically-delivered benchmark futures contracts. The Proposal sets forth a series of regulatory "carrots and sticks" (incentives and penalties) that encourage the migration of spot-month liquidity away from physically-delivered benchmark futures to lookalike cash-settled futures (and swaps). These incentives and penalties increase the cost of holding spot-month positions in physically-delivered futures contracts relative to cash settled contracts. By undermining spot-month liquidity in benchmark physically-delivered futures contracts, the various incentives and penalties in the Proposal will disrupt the price discovery function of those contracts—contrary to the express intent of Congress.[5] The effects of the Proposal on benchmark futures contracts are discussed further below in section II.B. of this comment letter.

The Proposal's non-spot-month limits exemplify many of the failings already discussed. Rather than a considered commodity-by-commodity analysis of what limits are appropriate, the Proposal uses a one-formula-fits-all open interest hard limits approach, which overrules, for unstated reasons, decades of market surveillance experience with accountability levels, which the Commission has previously approved and which Congress ratified twice, most recently in Dodd-Frank. In certain cases, the effect of the Proposal would be to reverse decades-old Commission-approved position limit frameworks. For example, in 1993, the Commission approved CME rules lifting all-months-combined limits for its live cattle, live hogs, and feeder cattle contracts to ensure necessary deferred month liquidity. The Commission did so in response to CME's analysis of all-months-combined limits as applied to continuously-produced and non-storable commodities. We discuss non-spot-month limits in section III of this letter.

The Proposal's position limit regime also arbitrarily targets as "speculative" certain valuable and prudent risk management activities that are beneficial to the public and to commodity markets. Non-speculative, sound risk management practices should be encouraged and protected, not deterred. A speculative position limits regime can do this with a sensible bona fide hedging exemption as well as other appropriate exemptions (including appropriate "intermarket" position exemptions), consistent with the purposes of CEA sections 4a(c) and 15(a)(2)(D). We discuss these problems in section IV of this letter.

In a companion release, the Commission proposes account aggregation rules for enforcing position limits that effectively equate a corporate commercial end-user to a commodity pool, and the commercial entity's corporate owners to non-passive commodity pool investors (see section VI of this comment letter). The account aggregation rules combined with the Proposal's provisions on bona fide hedging would require commercial end-users to impose enterprise-level risk management programs regardless of whether such programs would be economically appropriate in order to claim the bona fide hedging exemption (see section VI of this comment letter and our comment letter on "Aggregation of Positions" dated February 10, 2014).

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[5] *See* CEA sections 4a(a)(2)(C) & 4a(a)(3)(B); 7 U.S.C. §§ 6a(a)(2)(C) & 6a(a)(3)(B).

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Last, the Commission disregards its responsibility to assess the costs and benefits of its Proposal. It never considers the cost it will impose through a generic rather than a particularized commodity approach. It never considers the market liquidity impacts that relying on outdated deliverable supply estimate will cause. It never considers the potential impact on hedgers if the five times spot-month Proposal causes the expected demise of many physically-delivered contracts. It never considers how traditional hedgers will suffer from now being considered to be speculators. We raise these and other deficiencies with the CFTC's cost-benefit analysis in Section VII.

CME Group has worked with the Commission for many years to safeguard our markets. We will continue to do so to promote price discovery and market integrity. In that spirit, however, we urge the Commission to reconsider and revamp its Proposal for the reasons we spell out in this letter.

I. The Proposal is not in accordance with the law

The Proposal contains a multitude of legal deficiencies. In this section, we explain that:

- the Proposal's legal interpretation of its purported mandate to impose unnecessary limits should not be adopted as that interpretation finds no support in the statute's actual provisions, relevant legislative history, or the CFTC's own administrative precedent;
- the Proposal contravenes the statutory requirement for a particularized commodity determination for imposing position limits rather than a generic approach to all physical commodities;
- the Proposal's necessity finding is neither reasoned nor supportable; and
- the Proposal has disregarded or misapplied the statute's appropriateness standards resulting in a recommended framework that endangers price discovery in the United States in many commodities.

Most of these legal errors are pervasive and affect all aspects of the Proposal, rendering it not in accordance with law under the APA. Other legal defects in specific elements of the Proposal will be discussed later in the letter as part of our analysis of those elements.

A. The Proposal's statutory interpretation is flawed; when read holistically, the CEA authorizes, but does <u>not</u> mandate, the imposition of position limits

The Proposal's position limits framework rests on the same flawed legal claims asserted by the vacated 2011 position limit rules: "*Congress made the decision to impose limits*, and it is for the Commission to carry that decision out, subject to close Congressional oversight."[6] The United States District Court for the District of Columbia found that this legal basis—framed in terms of an unambiguous Congressional mandate to impose limits—was untenable.

[6] 78 Fed. Reg. at 75,682 (emphasis added).

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According to the district court, section 4a of the CEA, as amended by the Dodd-Frank Act, does not *clearly* require the Commission to impose position limits irrespective of the need for such limits, and the Commission therefore has a responsibility to bring its experience and expertise to bear "to fill in the gaps and resolve the ambiguities" in the statute.[7] Despite the district court's admonition, the Proposal has failed to fulfill this basic responsibility. As discussed further below, rather than engage with and resolve any ambiguous language in section 4a of the CEA, the Proposal has glossed over such language, basing its "Congress made us do it" rationale on a selective reading of the CEA that ignores provisions of law as well as on a misplaced reliance on certain Congressional findings and legislative history and a mischaracterization of the CFTC's own administrative experience that required the imposition of exchange-set (not CFTC) limits. Moreover, the Proposal has wholly ignored other provisions of the purported position limits mandate. Ultimately, and contrary to the Proposal's claims,[8] the "better reading" of the CEA—one that truly treats the statute as a coherent whole—is that the Commission has the qualified authority, not a mandate, to impose position limits.

1. <u>The Proposal selectively uses (and in some cases misreads) statutory text and provisions to support its preferred framework and claim of a position limits mandate</u>

The Commission's statutory position limits authority is found in section 4a of the CEA, as amended by Dodd-Frank. Even prior to Dodd-Frank, section 4a(a)(1) of the CEA provided the Commission with the authority to impose position limits "from time to time" "as the Commission finds are necessary to diminish, eliminate or prevent [burdens arising from excessive speculation]."[9] Dodd-Frank did not change this language, but added, among other amendments, language that "in accordance with the standards set forth [in section 4a(a)(1)]," the CFTC shall set limits on speculative positions in physical commodity futures and options "as appropriate."[10] The D.C. district court found these statutory phrases added by Dodd-Frank—"in accordance with the standards set forth [in section 4a(a)(1)]" and "as appropriate"—to be ambiguous. More specifically, with respect to the "in accordance with the standards set forth [in section 4a(a)(1)]" language, the district court noted that Congress left unclear "what 'standards' [it] meant to govern any limits set pursuant to Section [4a(a)(2)]" and whether those "standards" included section 4a(a)(1)'s requirement that the CFTC first find that position limits are necessary before imposing them (i.e., a "necessity" standard).[11] Similarly, the district court determined that it was unclear whether the phrase "as appropriate" modified the actual level of limits or modified the "shall" in section 4a(a)(2), so that the CFTC had the authority to determine that position limits were not "appropriate" and thus not to impose them at all.[12]

[7] *See International Swaps and Derivatives Association, et al. v. United States Commodity Futures Trading Commission*, 887 F. Supp. 2d 259, 281-82 (D.D.C. Sept. 28, 2012).

[8] *See* 78 Fed. Reg. at 75,682.

[9] CEA section 4a(a)(1); 7 U.S.C. § 6a(a)(1).

[10] CEA section 4a(a)(2); 7 U.S.C. § 6a(a)(2).

[11] *See* 887 F. Supp. 2d at 274-76.

[12] *See id.* at 276-78.

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The district court's decision compels the Commission to "recognize these ambiguities and interpret the statute accordingly in the first instance."[13] Yet, before addressing the "in accordance with the standards" and "as appropriate" language, the Proposal preemptively decides that the "better reading of the Dodd-Frank amendments" to CEA section 4a is that "the Dodd-Frank amendments *require* the Commission to impose position limits on physical commodity derivatives."[14] As with the Commission's statutory interpretation underpinning the vacated position limit proposal, the Proposal's interpretation here is a function of self-serving emphasis—and in some cases misreading—of selected statutory text and provisions in a manner inconsistent with an administrative agency's responsibility to effectuate the entirety of a statutory provision as written.

For example, the Proposal asserts that the words "shall" and "required" in CEA section 4a indicate that the statute mandates the imposition of limits, without fully considering the qualifying language related to those terms (e.g., "in accordance with the standards" and "as appropriate").[15] The Commission also rests its claims of a position limits mandate on section 4a(a)(2)(B)'s specification of timelines for establishing position limits.[16] However, in placing such great weight on the statutory timelines—which the Commission itself did not abide by—the Proposal again ignores other qualifying language in the statute which, as discussed below in section I.B., requires the CFTC to find that position limits are necessary and appropriate. Making such necessity and appropriateness findings are not incompatible with the statutory timeframes as the Commission suggests. Rather, to expedite the process of setting any limits, the Commission could have, as it did in requiring and administering exchange-set limits under Commission rule 1.61,[17] utilized the expertise of designated contract markets ("DCM") to determine whether position limits are necessary for a particular commodity and, if so, the appropriate types and levels of such limits and associated rules and exemptions.

As with other difficulties cited by the Proposal, moreover, the stringent timelines it uses to justify circumventing statutory safeguards is a difficulty manufactured by the Proposal itself. After all, it is the Proposal's own terms that establish its ambitious and unnecessarily expansive jurisdictional scope. It is the Proposal's own terms that attempt to apply untested limit levels to appreciably different commodity markets. It is the Proposal's own terms that seek to impose redefined and restrictive hedging and account aggregation standards that have never before been applied by the Commission. The Proposal is the progeny of proposed and vacated rules that have systematically manufactured problems and failed to adapt their requirements to account for the legitimate concerns raised by markets and market participants. Instead, as does the Proposal, they invoked alternatively maximal and minimalist interpretations of statutory provisions and text to justify their intransigence.

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[13] *See id.* at 278.

[14] *See* 78 Fed. Reg. at 75,682.

[15] *See id.*

[16] "(B) Timing (i) Exempt commodities For exempt commodities, the limits required under subparagraph (A) shall be established within 180 days after July 21, 2010. (ii) Agricultural commodities For agricultural commodities, the limits required under subparagraph (A) shall be established within 270 days after July 21, 2010." CEA section 4a(a)(2)(B), 7 U.S.C. § 6a(2)(B).

[17] *See* Establishment of Speculative Position Limits, 46 Fed. Reg. 50,938, 50,939 (Oct. 16, 1981).

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Looking beyond the text of CEA section 4a, the Proposal cites Dodd-Frank section 719 as confirmation that Congress mandated the imposition of limits. Dodd-Frank section 719 calls for a study by the CFTC, in consultation with the exchanges, of "the effects (if any) of position limits imposed pursuant to the other provisions of this title."[18] The CFTC argues that "Congress would not have required the Commission to conduct a study of the effects, 'if any,' of position limits . . . if the Commission had the discretion to not impose any position limits at all."[19] In light of the plain text of Dodd-Frank Section 719 and the broader purposes of CEA Section 4a, however, we believe that Congress intended for the study requirement to apply when the Commission exercises its discretion to impose position limits "as it finds are necessary" pursuant to CEA Section 4a(a)(1) or when designated contract markets ("DCMs") impose position limits "as necessary and appropriate" pursuant to CEA Section 5(d)(5). In short, nothing in Dodd-Frank Section 719 requires a study of position limits that must be imposed even if unnecessary.

2. The Congressional investigations and legislative history cited by the Proposal also do not show that Congress mandated position limits

The Proposal's attempt to rely on sources beyond the statute—specifically, Congressional investigations and findings and legislative history—also proves unavailing in demonstrating that Congress *required* the CFTC to impose position limits in the manner recommended by the Proposal. According to the Proposal, several Congressional investigations leading up to the enactment of Dodd-Frank found price volatility stemming from speculation in the crude oil and natural gas markets.[20] The Proposal, however, makes an illogical leap when it says that "[i]n light of these investigations and conclusions, it is reasonable for the Commission to conclude that Congress . . . did not intend to leave it up to the Commission whether there should be federal limits."[21] Even if the Congressional investigations cited by the Commission suggested that excessive speculation posed a burden on interstate commerce in certain physical commodity markets, those investigations did not conclude—nor does any other evidence of Congressional intent offered by the CFTC conclude—that speculative position limits *must* be imposed to address that burden. Indeed, the principle regulatory gap the Senate Permanent Subcommittee on Investigations identified in light of Amaranth's trading in natural gas in 2006 was not that any kind of position limits were needed to prevent "excessive speculation" exemplified by Amaranth, but rather that the position accountability rules in place at NYMEX, a DCM, were not in place for electronic, over-the-counter ("OTC") trading platforms like the InterContinental Exchange's ("ICE") ICE OTC platform.[22]

The Proposal similarly recounts the legislative history of the Dodd-Frank amendments in a misleading manner. In focusing on how that legislative history reflects a shift from discretionary language ("may") to mandatory language ("shall"),[23] the Proposal fails to acknowledge that the legislative history, in the

[18] Dodd-Frank section 719; 15 U.S.C. § 8307.

[19] 78 Fed. Reg. at 75,684.

[20] *Id.* at 75,682.

[21] *Id.*

[22] *See* Excessive Speculation in the Natural Gas Market, Staff Report with Additional Minority Staff Views, Permanent Subcommittee on Investigations, United States Senate, Released in Conjunction with the Permanent Subcommittee on Investigations, June 25 & July 9, 2007 Hearings ("Amaranth Report"), at 8.

[23] *See* 78 Fed. Reg. at 75,684-85.

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district court's words, also "reflects that Congress tied any new position limits to the 'standards' of the Commission's longstanding discretionary authority in Section [4a(a)(1)]."[24] In other words, the legislative history does not show that the Commission was stripped of any discretion not to impose position limits.

3. The Proposal glosses over statutory terms that the district court found to be ambiguous rather than resolving those ambiguities

Having come to the erroneous conclusion that a position limits mandate exists based on a selective reading of the statute and other sources, the Proposal then assumes that the language found to be ambiguous by the district court—i.e., "in accordance with the standards set forth [in section 4a(a)(1)]" and "as appropriate"—must be consistent with that mandate. In particular, the following statements of the Proposal demonstrate that it has assumed away rather than actually resolved the ambiguities in the statute:

- "*Because the Commission concludes that, when Congress amended section 4a(a) of the Act and directed the Commission to establish the 'required' limits, it did not want, much less require the Commission to make an antecedent finding of necessity for every position limit it imposes*, the 'standards' the Commission must apply in imposing the limits required by section 4a(a)(2) of the Act consist of the aggregation standard and the flexibility standard of CEA section 4a(a)(1), the same standards the Commission required exchanges to apply the last time there was a mandatory, prophylactic position limits regime."[25].

- "*Because . . . the [CFTC] believes it is reasonable to interpret CEA section 4a(a) to mandate the imposition of limits*, the words 'as appropriate' must refer to the level of limits, *i.e.*, the [CFTC] must set limits at an appropriate level."[26]

The Proposal 's first quote above (regarding the phrase "in accordance with the standards set forth [in section 4a(a)(1)]") refers to a 1981 Commission rulemaking on exchange position limits (the "1981 Rulemaking") that is inapposite to determining whether the "necessity" finding standard in section 4a(a)(1) is one of the standards referenced in the phrase "in accordance with the standards set forth [in section 4a(a)(1)]." The "standards" specifically enumerated in the 1981 Rulemaking and the relevant rule text did not include a necessity finding requirement or standard because the entire premise of the rulemaking was that the CFTC was *requiring* DCMs to impose exchange-set position limits based on the CFTC's antecedent judgment that speculative position limits were necessary for addressing the goals of CEA section 4a.[27] In the context of the CFTC's current proposal to impose federal limits, however, the Proposal has failed to show that Congress made an "antecedent judgment" that federal limits are necessary and appropriate for all physical commodity derivatives. Accordingly, whereas a "necessity" standard may not have made sense in the context of the 1981 Rulemaking, such a "necessity" standard

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[24] *See* 887 F. Supp. 2d at 283 & n.8.

[25] 78 Fed. Reg. at 75,684 (emphasis added).

[26] 78 Fed. Reg. at 75,685 n. 59 (emphasis added).

[27] *See* 46 Fed. Reg. at 50,939.

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should logically be included in section 4a(a)(2)'s reference to "the standards set forth [in section 4a(a)(1)]."

4. The Proposal wholly ignores other statutory provisions that undercut the purported position limits mandate

In addition to glossing over ambiguous language in CEA section 4a, the Proposal turns a blind eye to provisions that clearly contradict the purported position limits mandate. For example, the Proposal fails to recognize that Congress essentially endorsed position accountability levels as an alternative to position limits in the Commodity Futures Modernization Act of 2000 ("CFMA").[28] Indeed, the CFMA added section 5(d)(5) to the CEA, allowing DCMs to impose, as is necessary and appropriate, position limits *or* position accountability for speculators.[29] The Dodd-Frank Act did not eliminate or reduce the availability of position accountability in any way. Congress's endorsement of position accountability as a tool to address manipulation and other harms is inconsistent with the Proposal's argument that Congress *required* the Commission to impose position limits to address those same harms.

Similarly, CEA section 4a(e) undermines the Proposal's claim that position limits *must* be imposed irrespective of the need for such limits. Section 4a(e) states that, "*[I]f* the Commission shall have fixed limits under [section 4a] for *any contract* . . . then the limits fixed by the bylaws, rules, regulations, and resolutions adopted by such contract market, derivatives transaction execution facility, or electronic trading facility or such board of trade shall not be higher than the limits fixed by the Commission."[30] Section 4a(e)'s use of the term "if" to qualify the CFTC's fixing of limits under section 4a confirms that the CFTC is not required to impose position limits. Moreover, section 4a(e)'s reference to "any contract" signals that—contrary to the Proposal's assertions[31]—Congress was not imposing a position limit mandate for physical commodity derivatives while subjecting other contracts to the CFTC's section 4a(a)(1) authority to impose position limits "as [it] finds are necessary." Simply stated, the text of section 4a(e) demonstrates that the CFTC is authorized, not mandated, to impose limits on "any contract."

5. The Dodd-Frank amendments have practical significance and the CEA operates harmoniously when the CEA is construed to give the CFTC the conditional authority to impose position limits

The Proposal suggests that "finding that a mandate exists is the only way" for the Dodd-Frank amendments to the CEA to have significance.[32] In the Proposal's words:

> If there were no mandate [for agricultural and exempt commodities], then the same standards that apply to position limits for excluded commodities would also apply to agricultural and

[28] Pub. L. No. 106-554, 114 Stat. 2763A-365.

[29] 7 U.S.C. § 7(d)(5).

[30] CEA section 4a(e); 7 U.S.C. § 6a(e) (emphasis added).

[31] *See* 78 Fed. Reg. at 75,684.

[32] *See id.*

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exempt commodities and, basically, the Commission would have only permissive authority to promulgate position limits for any commodity—the same permissive authority that existed prior to the Dodd-Frank Act.[33]

The Proposal's view is short-sighted and incorrect. As shown in the following examples, the Dodd-Frank amendments would still have practical significance where CEA section 4a(a)(2) is construed to incorporate the "necessity" finding standard in section 4a(a)(1), so that the Commission could impose position limits on physical commodity derivatives only after it finds that such limits are necessary:

- The Dodd-Frank amendments to section 4a(a) guide the imposition of position limits for physical commodity derivatives once the CFTC finds that such limits are necessary. Specifically, sections 4a(a)(2)(C) and 4a(a)(3)(B), as added by Dodd-Frank, set forth safeguards that the CFTC must balance when it establishes limits for physical commodity futures and options under section 4a(a)(2).[34]
- Section 4a(a)(5) makes clear that, where the CFTC sets limits on physical commodity futures and options pursuant to section 4a(a)(2) (and hence "[i]n accordance with the standards set forth in [section 4a(a)(1)]," including the necessity standard), it must also establish limits, as appropriate, on economically equivalent swaps.[35]
- Section 4a(a)(5) also requires the CFTC to subject such limits on physical commodity futures and options and their economically equivalent swaps to similar requirements and to impose those futures, options, and swaps limits simultaneously.[36]

Excluding the necessity standard from section 4a(a)(2)'s reference to "the standards set forth in [section 4a(a)(1)]" would actually prevent the CEA from operating harmoniously. Under the Proposal's reading of the CEA, the CFTC would be *required* to impose federal position limits on *all* physical commodity derivatives even if such limits are not necessary. However, under section 5(d)(5), exchanges are authorized to impose position limits (or position accountability levels) on any derivatives traded on the exchanges, including physical commodity derivatives, only "as is necessary and appropriate."[37] Thus, the Proposal's statutory interpretation would result in the *very same* type of commodity derivatives—i.e., physical commodity derivatives—being subjected to two *different* standards for the imposition of limits: a mandate for the CFTC to impose limits even if unnecessary, and authority for exchanges to impose limits only as "necessary and appropriate." This statutory inconsistency (which the Proposal ignores) can be avoided by interpreting section 4a(a)(2) to incorporate the "necessary" finding requirement in section 4a(a)(1) so that the CFTC could impose position limits on physical commodity derivatives only after it finds that such limits are necessary.

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[33] *Id.*

[34] *See* CEA sections 4a(a)(2)(C) & 4a(a)(3)(B); 7 U.S.C. §§ 6a(a)(2)(C) & 6a(a)(3)(B).

[35] *See* CEA section 4a(a)(5); 7 U.S.C. § 6a(a)(5).

[36] *See* CEA section 4a(a)(5); 7 U.S.C. § 6a(a)(5).

[37] *See* CEA section 5(d)(5); 7 U.S.C. § 7(d)(5).

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Ultimately, by interpreting CEA section 4a as mandating CFTC limits for physical commodity derivatives without regard to necessity, the Proposal effectively is arguing for a repeal of section 4a(a)(1)'s "necessary" finding requirement as it relates to physical commodity derivatives. The Proposal, however, has not met the "high bar of showing an implied repeal."[38] In *Hunter v. FERC*, the D.C. Circuit held that a repeal by implication will only be found where intent to repeal is "clear and manifest" or "such a construction is absolutely necessary."[39] Here, the Proposal has offered no evidence of a clear and manifest congressional intent to repeal section 4a(a)(1)'s "necessary" finding requirement with respect to physical commodity derivatives or convincingly shown that repeal of the "necessary" finding requirement is an "absolutely necessary" construction. Indeed, as discussed above, the "necessary" finding requirement in section 4a(a)(1) is consistent with the overall framework of the CEA, including the Dodd-Frank amendments to the CEA.

B. In order to exercise its position limits authority under the CEA, the Commission must find that position limits are "necessary" and "appropriate" on a commodity-by-commodity basis

The D.C. district court found that the language in CEA section 4a(a)(1) that was left un-amended by Dodd-Frank—referring to the CFTC promulgating limits "as the CFTC finds are necessary"—unambiguously requires the CFTC to make a necessity finding before imposing position limits.[40] However, the court said that Congress did not make clear whether the Dodd-Frank amendments adding other language in the CEA required the CFTC to impose position limits without making such a finding.[41] As discussed above, under the "better reading" of the Dodd-Frank amendments to the CEA, CEA section 4a(a)(2) reaffirms that the Commission must set position limits "in accordance with the standards set forth in [section 4a(a)(1)]," which standards include the requisite "necessity" finding. Section 4a(a)(2) further provides that any position limit regime found to be "necessary" may only be established "as appropriate."[42] The following sections further discuss the requisite necessity and appropriateness findings that the CFTC must make in order to impose position limits.

1. <u>Necessity Finding</u>

By its terms, CEA section 4a(a)(1) requires, as a precondition to imposing position limits, that the CFTC find that the limits are "necessary" with respect to a *particular commodity*. More specifically, CEA section 4a(a)(1) states in relevant part that:

> Excessive speculation in *any commodity* under contracts of sale of *such commodity* for future delivery . . . or swaps . . . causing sudden or unreasonable fluctuations or unwarranted changes in the price of *such commodity*, is an undue and unnecessary *burden on interstate commerce in such commodity*. For the purpose of diminishing eliminating, or preventing *such burden*, the

[38] *See Hunter*, 711 F.3d at 160.

[39] See *id.* at 159-60.

[40] *See* 887 F. Supp. 2d at 269.

[41] *Id.* at 282.

[42] CEA section 4a(a)(2); 7 U.S.C. § 6a(a)(2).

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> Commission shall fix such limits on the amounts of . . . positions which may be held any person . . . under contracts of sale of *such commodity* for future delivery . . . or swaps . . . as the Commission finds are necessary to diminish, eliminate, or prevent *such burden*.[43]

The CFTC's administrative precedent further confirms that the statutorily required necessity finding for imposing CFTC limits must be tied to the characteristics of a particular commodity market. Indeed, over the course of 45 years, the CFTC's predecessor agency imposed speculative position limits with respect to an individual commodity only after making findings of fact, and after notice and opportunity to comment, supporting the need to impose the limits and the actual levels of those limits.[44]

The Proposal attempts to rely on the Commission's 1981 Rulemaking to support the notion that, pre-Dodd-Frank, the Commission was not required to make particularized, commodity-by-commodity necessity findings before imposing CFTC limits. According to the Commission,

> When the Commission imposed limits pre-Dodd-Frank it only had to *determine that excessive speculation is harmful to the market and that limits on speculative positions are a reasonable means of preventing disruptions in the marketplace that place an undue burden on interstate commerce*. That is the determination that the Commission made in 1981 when it required the exchanges to establish position limits on all futures contracts, *regardless of the characteristics of a particular contract market*.[45]

The 1981 Rulemaking did not, however, concern CFTC limits or address the issue of whether the CFTC would have to make a necessity finding if it adopted such limits and what type of necessity finding it would have to make. Accordingly, the 1981 Rulemaking does not trump the text of section 4a(a)(1), which calls for the Commission to make commodity-specific necessity findings, or the body of precedent in which the Commission and its predecessor agency made such particularized findings. Moreover, the 1981 Rulemaking cannot stand for the notion that the Commission can avoid a particularized, commodity-by-commodity analysis before establishing a position limits regime, as discussed immediately below.

2. <u>Appropriateness Finding</u>

In addition to making a necessity finding as discussed above, the Commission must determine that any position limit regime it imposes is "appropriate" ("appropriateness finding").[46] To make this appropriateness finding, the Commission must address a series of six statutory safeguards ("Six Safeguards"). Specifically, the Commission must meet the "goals" of CEA section 4a(a)(2)(C) by

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[43] CEA section 4a(a)(1); 7 U.S.C. § 6a(a)(1) (emphasis added).

[44] *See* 78 Fed. Reg. at 75,683 (discussing predecessor agency's findings of necessity in rulemakings establishing position limits).

[45] *Id.* n. 34 (emphasis added).

[46] We note that in our interpretation of the "as appropriate" language in CEA section 4a, as amended by Dodd-Frank, that language refers to both: (1) the antecedent judgment on whether to impose position limits at all, and (2) the limit levels and associated rules (e.g., bona fide and other exemptions, aggregation requirements, etc.).

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"striv[ing] to ensure" that (Safeguard 1) "trading on foreign boards of trade in the same commodity will be subject to comparable limits" and (Safeguard 2) "that any limits to be imposed by the Commission will not cause price discovery in the commodity to shift to trading [to foreign boards of trade ("FBOTs")]."[47] CEA section 4a(a)(3)(B) directs the Commission to address four additional safeguards, "to the maximum extent practicable," when exercising its authority under CEA section 4a(a)(2):

- (Safeguard 3) to diminish, eliminate, or prevent excessive speculation causing sudden or unreasonable fluctuations or unwarranted changes in price;
- (Safeguard 4) to deter and prevent market manipulation, squeezes, and corners;
- (Safeguard 5) to ensure sufficient market liquidity for bona fide hedgers; and
- (Safeguard 6) to ensure that the price discovery function of the underlying market is not disrupted.[48]

The Six Safeguards were added by the Dodd-Frank Act and therefore circumscribe the Commission's authority to impose speculative positions under CEA section 4a(a)(2) – in a manner that is more prescriptive than CEA section 4a(a)(1). In order to establish speculative position limits that address these Safeguards "to the maximum extent practicable," the Commission would need to consider on an individual basis each commodity it seeks to subject to limits because the calculus required to fully effectuate these Safeguards would differ based on characteristics specific to each commodity market. For example, the Commission's consideration of Safeguard 2 entails a consideration of each commodity individually. This is because in order to "ensure" that price discovery in the "same commodity" does not migrate overseas, the Commission should take into account whether the commodity at issue is international (therefore overlying contracts are more likely to suffer from regulatory arbitrage) and, if so, whether the commodity contract is subject to comparable position limits rules abroad.[49] To determine whether a contract is subject to comparable rules, the Commission must also consider a contract's underlying market liquidity (e.g., the more liquid a market, the less susceptible an overlying contract is to undue fluctuations in price caused by excessive speculation and the less likely it is to being manipulated) and other market structure characteristics (e.g., the more constraints there are on demand or supply, the more susceptible an overlying contract is to manipulation).[50]

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[47] *See* CEA sections 4a(a)(2)(C); 7 U.S.C. § 6a(a)(2)(c).

[48] CEA section 4a(a)(3)(B), 7 U.S.C. § 6a(3)(b).

[49] See infra below at section D, discussing concerns regarding migration of liquidity to foreign markets.

[50] The Commission has in the past found that for commodity markets with "a high degree of liquidity" position accountability rules would be adequate to address concerns relating to excessive speculation. Speculative Position Limits-Exemptions From Commission Rule 1.61; Comex Proposed Amendments to Rules 4.47 and 4.48, 57 Fed. Reg. 29,064, 29,065-29,066 (June 30, 1992) (also noting that speculative position limits are not necessary in commodities that "have substantial forward markets that readily are arbitraged with the futures of [sic] option markets"). Similarly, in the 1980 proposal that when finalized provided the Commission the administrative precedent on which it bases its view that it need not make commodity-by-commodity necessity findings, the Commission cited a report from its Office of the Chief Economist which found that "the greater breadth of supply, storability, and fungibility of the commodity along with lower transportation costs, ease of delivery, and liquidity in the cash and futures markets tend to promote (but do not guarantee) arbitrage between the cash and futures markets. This arbitrage, if it exists to any appreciable degree, causes the cash and futures markets to be highly interrelated, thus limiting the potential for a large position in futures to influence price levels." Speculative Position Limits, 45 Fed. Reg. 79,831, 79,832-79,833 (Dec. 2, 1980) citing "Speculative Limits," a staff paper prepared for

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The CFTC's administrative precedent confirms that setting "appropriate" limits for an individual contract requires an inquiry into the characteristics of that commodity market. Again, over the course of 45 years, the CFTC's predecessor agency imposed speculative position limits with respect to an individual commodity only after making findings of fact supporting the need for the limits *and* the actual level of those limits.[51] In 1992, the Commission stressed that "the fundamental tenet in the Commission's setting of speculative position limits must be 'based upon the individual characteristics of a specific contract market.' The corollary to this principle is that not all speculative position limits for all types of commodities necessarily will be the same."[52]

In suggesting that the Commission's 1981 Rulemaking demonstrates that position limits may be imposed "irrespective of the characteristics of the underlying market,"[53] the Proposal ignores the history and structure of the CEA at the time of that rulemaking as well as language in the 1981 Rulemaking. When the 1981 Rulemaking was adopted, the CEA provided for a board of trade to be designated as a DCM in individual commodities. Accordingly, DCMs subject to the 1981 Rulemaking necessarily would be establishing limits for futures and options listed for trading in specific commodities and, in setting such limits, making particularized commodity-by-commodity determinations. Furthermore, the 1981 Rulemaking actually required a careful inquiry into the characteristics of individual contract markets in order to determine position limits "most appropriate" for the individual contract market."[54] The Commission found in that rulemaking that specific speculative position limits designed to combat excessive speculation should be carefully calibrated so as not to "interfere with normal trading patterns or significantly impact market liquidity or pricing efficiency . . . [or] cause [the preponderance] of speculative traders to conduct their trading in a foreign futures market."[55] The Commission then

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Commission discussion by the Office of Chief Economist, Jun. 24, 1977, at 19-20. Similarly, the same proposal found that speculative position limits should consider factors "which might bear on the effect individual position sizes have on price such as the breadth and liquidity of the cash market underlying each delivery month, and any such factors that a contract market might wish to bring to the attention of the Commission." *Id.* at 79,834. These suggestions were later incorporated in the Commission's position limits regulations. See 17 C.F.R. 1.61(a)(2)(1991).

[51] *See* supra note 40.

[52] Revision of Federal Speculative Position Limits, 57 Fed. Reg. 12,766, 12,770 (Apr. 13, 1992) (citing 52 Fed. Reg. at 6,815).

[53] 46 Fed. Reg. at 50,940 ("[CEA section 4a] represents an express Congressional finding that excessive speculation is harmful to the market, and a finding that speculative limits are an effective prophylactic measure." Consistent with this, the Commission promulgated rules directing DCMs to "employ their knowledge of their individual contract markets to propose the position limits they believe most appropriate."). In other words, DCMs' deployment of "knowledge" of an "individual contract market" allowed DCMs to implement position limits "most appropriate" for that market. *Id; see also* 17 C.F.R. § 1.61(a)(2) (1981).

[54] 46 Fed. Reg. at 50,940

[55] *Id.* at 50,940-50,941 ("The Commission is aware that speculation is often an important contributing factor to market liquidity and pricing efficiency. . . . In this respect, the Commission indicated that in its review of proposed [DCM] speculative limits, it will consider the historical distributions of speculative positions considering, among other things, recent trends in position patterns, the frequency of positions occurring at different levels and the levels at which occur the preponderance of speculative positions normally observed in the market. In view of this,

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directed the DCMs, because of their "knowledge of their individual contract markets," to balance these considerations and to "determine the most efficacious level at which position limitations may be established."[56] Thus, the Commission found that a careful inquiry was necessary to impose position limits that "most appropriately" addressed these considerations and found that the DCMs were best equipped to undertake that type of inquiry.

The following chart demonstrates that the Dodd-Frank amendments to the CEA and the 1981 Rulemaking contemplated the same type of particularized commodity inquiry. A high-level comparison of the Six Safeguards and the considerations the Commission directed DCMs to undertake in the 1981 Rulemaking shows their similarity and particular commodity focus:

Six Safeguards (CEA sections 4a(a)(2)(C) and 4a(a)(3)(B))	**1981 Rulemaking**
Safeguards 1 and 2 – " Commission shall strive to ensure that trading on foreign boards of trade in the same commodity will be subject to comparable limits and that any limits to be imposed by the Commission will not cause price discovery in the commodity to shift to trading on the foreign boards of trade."	DCMs should set position limits at a level that would not "cause [the preponderance] of speculative traders to conduct their trading in a foreign futures market."[57]
Safeguards 3 and 4 – Commission should aim "to diminish, eliminate, or prevent excessive speculation" that causes "sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity" and "to deter and prevent market manipulation, squeezes, and corners."	DCMs should prevent "traders from obtaining extraordinarily large speculative positions."[58]
Safeguard 5 – Commission should "ensure sufficient market liquidity for bona fide hedgers."	DCMs should aim not to "significantly impact market liquidity."[59]
Safeguard 6 – Commission should "ensure that the price discovery function of the underlying market is not disrupted."	DCMs should aim not to "interfere with pricing efficiency."

In contrast to 1981, when the Commission deferred to DCMs and their knowledge of individual commodity markets to set "appropriate" position limits and related rules, the Proposal would set limits and related rules imprudently, ignoring the individual characteristics of different commodity markets. Overall, the text of CEA section 4a, as amended by Dodd-Frank,[60] together with the CFTC's own

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the Commission believes that the [DCMs] will be able to establish position limits that will prevent the adverse effects of extraordinary large speculative positions but which will not interfere with normal trading patterns or significantly impact market liquidity or pricing efficiency.").

[56] *Id.* at 50,939.

[57] *Id.* at 50,941. [58] *Id.* (citing 45 Fed. Reg. 79,833).

[58] *Id.* (citing 45 Fed. Reg. 79,833).

[59] *Id.*

[60] We note that the fact that Congress provided, in CEA section 4a(a)(2)(B), for different types of commodities (i.e., agricultural versus metals and energy) to have different timelines for setting limits lends further support to our

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precedent, confirm that the CFTC must find that the position limits it seeks to impose are "appropriate" through undertaking a careful, commodity-by-commodity analysis of several countervailing Safeguards.

C. The Proposal fails to offer necessity findings and appropriateness findings that are consistent with the CEA

The Proposal lacks the particularized, commodity-by-commodity necessity and appropriateness findings required by the CEA. Subsequent sections of this comment letter will discuss how key features of the proposed position limit regime are not appropriate precisely because they do not take into account the intrinsic characteristics of each commodity market. With respect to a necessity finding, the Proposal offers—as a "separate and independent basis" for its limits and requirements[61]—a general determination that "excessive speculation is harmful to the market and that limits on speculative positions are a reasonable means of preventing disruptions in the marketplace that place an undue burden on interstate commerce."[62] In other words, the Proposal's so-called necessity finding is not actually a finding that limits are *necessary* for a particular commodity market, but rather a broad assertion that position limits "are a reasonable means" of addressing burdens on interstate commerce. On its face, the Proposal's necessity finding does not comply with the CEA's requirements as discussed above.

Moreover, the "evidence" that the Proposal cites as support for its necessity finding does not actually show that its position limits are necessary. After providing a very limited overview of studies that the Commission reviewed, the Proposal acknowledges that those studies "show a lack of consensus regarding the impact of speculation on commodity markets and the effectiveness of position limits." Nevertheless, the Proposal asserts that "*[i]n light of the Commission's experience with position limits, and its interpretation of Congressional intent*, it is the Commission's judgment that position limits should be implemented as a prophylactic measure, to protect against the potential for undue price fluctuations and other burdens on commerce that in some cases have been at least in part attributable to excessive speculation." (emphasis added).

Each of the bases identified by the Proposal for imposing position limits as a "prophylactic measure," whether on their own or together, is woefully inadequate support for the statutorily required necessity finding. The Proposal's reference to the Commission's "experience with position limits" offers no concrete support given that it does not describe that experience or what that experience teaches. We note that for 19 of the 28 referenced contract commodities the Commission does not have experience administering position limits and, as discussed above in Section I.B.2., has historically deferred to the expertise of DCMs for determining the appropriate policy tools, position limits or accountability rules, to address the purposes of section 4a of the Act. Similarly, the Proposal's reliance on the CFTC's "interpretation of Congressional intent" is misplaced not only because that interpretation is flawed, but also because a statutory interpretation cannot be substituted for the empirical evidence needed to

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contention above that Congress intended that speculative position limits were to be predicated by a careful inquiry into each individual physical commodity contract market.

[61] *See* 78 Fed. Reg. at 75,685.

[62] *See id.* at 75,683 n. 34.

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support a fact-driven necessity finding. And, finally, apart from two case studies discussed below, the Proposal does not offer any qualitative analysis of the "some cases" where "undue price fluctuations . . . have been at least in part attributable to excessive speculation." CME Group agrees with Commissioner O'Malia that the Commission cannot "be 'experts,' if [it] does not have the data to back [it] up."[63]

The only two studies of actual market events that the Proposal discusses at any length—studies that the Proposal found to "be helpful and persuasive in making its alternative necessity finding"[64]—are actually limited, outdated, and unpersuasive "evidence." Each study focuses on the activities of a *single* market participant in a *single* market during a *limited timeframe* that occurred *years ago*. Furthermore, neither study states that position limits were *needed* to address any burdensome excessive speculation at issue in those cases. The first study—an inter-agency report on the Hunt Brothers' activities in the silver market in 1979-1980—merely concluded that "[r]easonable speculative position limits, if they had been in place before the buildup of large positions occurred, would *have helped prevent* the accumulation of such large positions and the resultant dislocations created when the holders of those positions stood for delivery."[65] The second study—a U.S. Senate Permanent Subcommittee on Investigations Report that focuses on Amaranth's trading in the natural gas market in 2006—remarked that "[t]he Amaranth experience demonstrates how excessive speculation can distort prices of futures contracts that are many months from expiration"[66] but did not conclude that position limits were necessary to diminish, eliminate, or prevent burdensome excessive speculation. Although the Proposal asserts that the second study's findings "support the imposition of speculative position limits outside the spot month,"[67] the Amaranth experience does not show that such position limits are *necessary*, as discussed in detail in Section III.B.

Indeed, CME Group maintains that the Commission would be hard pressed to show that position limits are *necessary* for many contracts outside of the spot month where flexible position accountability levels are an effective alternative to hard limits. As noted above, through amendments to the CEA in 2000 which were reaffirmed by Dodd-Frank, Congress endorsed position accountability as a tool to address manipulation and other price disruptive activities. Moreover, existing exchange programs that employ position accountability levels outside the spot month have proven to be effective. Because position accountability measures may not be effective in the spot month, CME Group believes that the CFTC could find that federal spot-month *limits* are necessary to address inter-exchange or cross-market surveillance concerns. However, the Commission would still be required by statute to make individualized, commodity-by-commodity necessity and appropriateness findings to support the imposition of any federal limits.

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[63] Statement of Dissent by Commissioner Scott D. O'Malia, Notice of Proposed Rulemaking for Position Limits for Derivatives, http://www.cftc.gov/PressRoom/SpeechesTestimony/omaliastatement110513 (Nov. 5, 2013).

[64] 78 Fed. Reg. at 75695.

[65] *See id.* at 75,686 (quoting Commodity Futures Trading Commission, Report To The Congress In Response To Section 21 Of The Commodity Exchange Act, May 29, 1981, Part Two, A Study of the Silver Market, at 173).

[66] *See id.* at 79,652 (quoting Amaranth Report at 4).

[67] *See id.* at 75,692.

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D. The Commission fails to consider the international impact its proposal would have

The Proposal fails altogether to even mention, let alone "strive to ensure," a Safeguard Congress directed the Commission to achieve through its position limit rules: that price discovery does not shift to foreign markets.[68] This Safeguard was important enough to Congress that it also required the Commission to issue a report on the effect of its rules on "the movement of transactions from exchanges in the United States to trading venues outside the United States" one year after establishing any position limits under CEA section 4a(a)(2).[69] The Proposal ignores Congress on this point despite the very real potential that an overly restrictive position limits regime, such as the one the Proposal sets forth, could create powerful incentives encouraging the migration of price discovery to foreign markets.

As noted above, the Commission must meet the "goals" of CEA section 4a(a)(2)(C) by "striv[ing] to ensure" that (Safeguard 1) "trading on foreign boards of trade in the same commodity will be subject to comparable limits" and (Safeguard 2) "that any limits to be imposed by the Commission will not cause price discovery in the commodity to shift to trading [to foreign boards of trade ("FBOTs")]." We are particularly concerned about the impact the Proposal, if adopted, would have on U.S. commodities markets with foreign markets are years away from the possibility of imposing position limits. Under the Proposal, DCMs would have to adopt and enforce onerous and indefensible bona fide hedging rules and account aggregation standards for referenced contracts subject to the Proposal's federal position limits proposal and for all other commodity market contracts. Trading facilities abroad, however, including registered foreign boards of trade FBOTs that offer look-a-like, cash-settled products to U.S. traders would not be required to implement similar rules.

In part 48 of its regulations, the Commission has implemented new registration authority over FBOTs that was provided in the Dodd-Frank Act. More specifically, 17 C.F.R. § 48.8(c)(1)(ii)(A) requires FBOTs, as a condition of registration if they provide direct access to US customers, to adopt comparable "position limits (including related hedge exemptions)" for all contracts that are linked to those listed for trading on a registered entity, e.g., a DCM or a SEF). Notably absent from the Proposal, however, is any consideration of how comparability will be achieved with regard to bona fide hedging rules and other position limit exemptions, or any acknowledgment that comparability cannot be achieved without identical account aggregation rules. The Proposal also fails to discuss FBOT contracts, also discussed in part 48, that are related but not linked to contracts traded on registered entities that for example are based on the same third-party constructed index.

The failure to address discrepancies, and the alternative of expanding the same hedging requirements and account aggregation rules to FBOTs, which the Commission should consider adopting, can plant the foundation for regulatory arbitrage and contradicts Congressional intent and the express requirements of section 4a of the Act.

II. The Commission's spot-month limit proposal should not be adopted

[68] CEA section 4a(a)(2)(C), 7 U.S.C. § 6a(2)(C).

[69] Dodd-Frank section 719, 15 U.S.C. § 8307.

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CME Group opposes the Proposal on spot-month limits for several reasons. First, the Proposal is based on antiquated deliverable supply data that to varying degrees distorts the prevailing cash market structure for each of the 28 commodities referenced by the Proposal. Deliverable supply estimates are the foundation of spot-month limits. They must reflect current market conditions to the greatest extent possible. Second, the Proposal contains a disingenuous spot-month regime for all 28 physical commodities—as if all physical commodities are the same—and would increase the risk of price manipulation, harm price discovery, promote perceived excessive speculation, harm hedgers and help foreign competitive markets. This misguided approach would set in motion market forces that could easily lead to the demise of physically-delivered commodity futures markets, a result Congress expressly directed the CFTC to avoid and a cost the Proposal never acknowledges, let alone analyzes.

A. The Commission should endorse accurate, current deliverable supply estimates; the Proposal's reliance on estimates that are neither accurate nor current is arbitrary and capricious

Spot-month position limits have long been set as a function or percentage of estimated deliverable supply. The Proposal follows the same formula.[70] But the Proposal is less than transparent on what it believes to be an accurate estimate of deliverable supply for today's markets.

As we understand the Proposal, the Commission would at least initially set federal spot-month limits at limit levels reflecting deliverable supply estimates that are very much out of date; for example, the silver and gold deliverable supply estimates date back to 1983 and the natural gas deliverable supply estimate is based on 1996 market conditions. The deliverable supply estimates reflected in the limit levels the Commission would adopt are under-inclusive as well because they were reviewed under standards that excluded supply committed for long-term agreements.

Because estimates of deliverable supply are a cornerstone of the Proposal's spot-month limit framework, the use of updated deliverable supply estimates, and the spot-months limits derived from them, is more than warranted. CME provided such an update on July 1, 2013. The CFTC has not accepted these estimates. The Proposal merely asks for comment on them and refers DCMs to appendix C of part 38 for guidance on how to determine estimates of deliverable supply.[71] Appendix C, amended by the Commission in 2011, provides that estimated deliverable supply "would not include supply that is committed for long-term agreements (i.e., the amount of deliverable supply that would not be available to fulfill the delivery obligations arising from current trading)." Appendix C provides for a limited exception, saying that if "estimated deliverable supply that is committed for long-term agreements, or significant portion thereof, can be demonstrated by the designated contract market to be consistently and regularly made available to the spot market for shorts to acquire at prevailing economic values, then those 'available' supplies committed for long-term contracts may be included in the designated contract market's estimate of deliverable supply[.]"[72] Supply falling into this exception

[70] *See* 78 Fed. Reg. at 75,728.

[71] *Id.* at 75,727.

[72] Appendix C to 17 C.F.R. part 38.

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was not taken into account in determining the existing exchange limit levels that, under the Proposal, would be used in setting initial federal spot-month limit levels.

Commission action with respect to deliverable supply should effectuate the Commission's own guidance in Appendix C and must take new cash market structures into consideration, particularly as they relate to long-term contracts. For example, today's natural gas wholesale markets are largely reseller markets dominated by commercial merchandizers, both affiliated and unaffiliated with producers and end-users. Re-selling is the predominant market activity but first-sales do commonly take place in this market (as do final-sales). However, the first-sales are typically from a producer to a merchandizer-firm; final sales are typically from a merchandizer-firm to an end-user. These merchandizer-firms consist mostly of marketers, aggregators, producer marketer-affiliates, end-user marketer affiliates and other commercial cash market intermediaries. NYMEX futures contracts actually overlay most of the dozens of common reseller wholesale market centers which form the core and skeleton of the North American natural gas commercial market. In addition, the NYMEX flagship Natural Gas physical delivery futures contract overlays one of the specific reseller wholesale market centers. Under this market structure, and notwithstanding that very large percentages of natural gas may be subject to long-term agreements, virtually all natural gas is available for delivery (and re-delivery). Commission and exchange deliverable supply analysis must be based on prevailing market conditions and an accurate understanding of long-term contracts, to meaningfully effectuate regulations incorporating such analysis.

As demonstrated by the data submitted by CME, actual deliverable supplies under new Appendix C can be vastly different than the antiquated and under-inclusive deliverable supply estimates implied by current spot-month limit levels that the Proposal seeks to federalize. We therefore urge the Commission to recognize the alternative spot-month limit levels that are based on updated deliverable supply estimates and that are listed in Table 9 of the Proposal as reflecting appropriate deliverable supply estimates. CME expended significant resources in calculating updated estimates of deliverable supply. We believe that the analysis supporting the data is in line with Commission guidance and consistent with the purposes of CEA section 4a when used to derive spot-month position limits.

Indeed, if the Commission were to set initial federal spot-month limit levels at the levels currently in place at DCMs—which, again, are based on outdated and under-inclusive deliverable supply estimates—the Commission would be acting arbitrarily and capriciously under the APA. A hallmark of an arbitrary and capricious agency action is the lack of a reasoned basis for the action.[73] Here, the Proposal has not offered, nor could it offer, a sound rationale for adopting federal spot-month limit levels at the current DCM limit levels. The Proposal rationalizes setting "initial spot-month limit levels at the existing DCM-set levels for the core referenced futures contracts because the Commission believes this approach is consistent with the regulatory objectives of the Dodd-Frank Act amendments to the CEA and many market participants are already used to these levels." 78 Fed. Reg. 75727. This explanation is premised on the following ***erroneous assumptions*** and therefore cannot be considered a reasoned basis:

[73] *See Burlington Truck Lines v. United States*, 371 U.S. 156, 168 (1962) (stating that an agency must articulate a satisfactory explanation for its action including a "rational connection between the facts found and the decision made"); *see also APSCU v. Duncan*, Case No. 1:11-CV-01314-RC, Dkt. 25 at 1 (D.D.C. June 30, 2012) (vacating a debt measure regulation as arbitrary and capricious because it "lack[ed] a reasoned basis").

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1) The DCM limit levels now in force reflect current market conditions, which must be considered in balancing regulatory objectives to set limits under the CEA as amended by Dodd-Frank; and

2) The current DCM levels would function under the CFTC's proposed position limits framework as they currently function under the CFTC's existing position limits regime.

With respect to the first assumption, as noted above, the current DCM limit levels (on which the CFTC proposes to base initial federal limit levels) reflect outdated and under-inclusive deliverable supply estimates and are therefore artificially low. Adopting such DCM levels as the initial federal spot-month limit levels would thus not be consistent with the Dodd-Frank regulatory objectives of ensuring adequate liquidity for bona fide hedgers, preventing disruption of the price discovery function of the underlying benchmark futures markets, or preventing burdensome *excessive* speculation.[74] The second assumption is likewise patently false because the current DCM levels—levels that the Proposal asserts "market participants are already used to"—would function differently under the its proposed position limits regime. Compared to the current position limits framework, the proposed position limits regime consists of inflexible and overly restrictive features, such as the bona fide hedging requirements and aggregation standards, which would exacerbate the artificially low limit levels. For example, spot-month position limits currently are applied per execution venue and not at all in the swaps markets. Considering a contract offered on two exchanges, and leaving aside the impact of limits on swaps, the Proposal's aggregate spot-month limit would effectively halve current spot-month limits for traders active in both markets. Because DCMs would be required to enforce these aggregate limits, spot-month limit levels would be federalized under the Proposal's framework and would not be the same levels that market participants are used to today.

The Proposal not only relies on erroneous assumptions for adopting initial federal spot-month limits at current DCM limit levels, but also fails to consider the practical and legal implications of such a proposal. If current DCM limit levels become federal limit levels, under CEA section 5(d)(5)(B), DCMs will not be allowed to set DCM levels higher than those federal levels.[75] Being locked into artificially low limit levels would conflict with another DCM obligation under CEA section 5(d)(5)(A) to set limits "as necessary and appropriate."

Moreover, given that DCMs would have to maintain artificially low limit levels by operation of CEA section 5(d)(5)(B), and in light of the liquidity pipeline to cash-settled contracts that is created by the proposed framework's more permissive cash-settled spot-month limits, liquidity in underlying benchmark physically-delivered futures may very well shift to cash-settled markets. As discussed further below in section II.B., this misallocation of liquidity could impair price convergence between the futures and cash markets. Ensuring price convergence is critical to the price discovery process, which DCMs have a legal obligation to protect under CEA Section 5(d)(9).[76] Thus, in effect, the federalizing of the current, artificially low DCM spot-month limit levels would compromise a DCMs' ability to comply with

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[74] *See* CEA section 4a(a)(3)(B); 7 U.S.C. § 6a(a)(3)(B).

[75] *See* CEA section 5(d)(5)(B); 7 U.S.C. § 7(d)(5)(B).

[76] *See* CEA section 5(d)(9); 7 U.S.C. § 7(d)(9).

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its legal obligations under the CEA. The Proposal's failure to consider these implications also signals a lack of reasoned decision-making and hence an arbitrary and capricious agency action.

If the Commission begins by embracing accurate and current deliverable supply estimates for each of the 28 commodities at issue, the Commission may then rationally proceed to seek comment on a proposed federal spot-month limit. Until commentators understand what the deliverable supply estimate is, meaningful comment on the Proposal is precluded. Developing an operating estimate of deliverable supply should be the Commission's first order of business in setting out a spot-month limit proposal.

Ultimately, any Commission-driven process for determining the applicable deliverable supply estimate should be transparent and understandable. Under proposed rule 150.2(e)(3)(ii), spot-month limits would be set at 25% of estimated deliverable supply for the referenced contract's underlying commodity. These estimates of deliverable supply would be determined by DCMs offering for trading the pertinent core referenced futures contract. The Proposal indicates that the Commission will defer to the DCM's estimate of deliverable unless it "determines to rely on its own estimate."[77] The Proposal does not give notice of what factors the Commission would utilize in evaluating a DCM estimate or in developing its own. Nor does the Proposal, should the Commission decide to "rely on its own estimate," contemplate allowing for notice and comment of these deliverable supply estimates. We urge that the Commission provide the public with further explanation on these points and to provide as much transparency as possible.

B. The Proposal's distortions raise the cost of holding spot-month positions in physical-delivery contracts relative to spot-month positions in cash-settled contracts, thereby artificially misallocating spot-month liquidity in contravention of specific CEA provisions

Several of the Proposal's restrictions, seemingly by design but without any specific discussion of their intent or impact, cumulatively would pressure liquidity away from benchmark physical-delivery futures to look-a-like cash-settled futures and swaps. The Proposal would do this first by imposing regulatory conditions on large spot-month positions in physically-delivered benchmark futures that would not be imposed on cash-settled contracts. This disparate treatment would increase the cost of large spot-month positions in physically-delivered benchmark futures relative to spot-month positions in cash-settled contracts. The restrictions that specifically target physically-delivered benchmark futures include:

- Setting initial spot-month limits at artificially low levels based on (1) an overly narrow conception of "estimated deliverable supply" and (2) materially outdated deliverable supply estimates;

[77] Proposed rule 150.2(e)(3)(i) ("No less frequently than every two calendar years, the Commission shall fix the level of the spot-month limit no greater than one-quarter of the estimated spot-month deliverable supply in the relevant core referenced futures contract. Unless the Commission determines to rely on its own estimate of deliverable supply, the Commission shall utilize the estimated spot-month deliverable supply provided by a designated contract market.").

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- As discussed in detail in section IV below, disallowing bona fide hedge exemptions for physically-delivered spot-month positions (or positions in the last five days of trading, whichever is shorter) under the so-called "five day rule" that would be inapplicable to cash-settled contract positions; and

- As discussed in section V below, for non-referenced contracts, limiting the Proposal's narrow "intermarket spread" exemption to spot-month positions in cash-settled contracts only.

Next the Proposal, through significantly higher spot-month limits for cash-settled contracts, would further pressure liquidity away from benchmark futures to cash-settled contracts. The higher cash-settled contract limit, which is discussed in detail below in section II.C., would dramatically lower the relative cost of spot-month position capacity in cash-settled contracts that to varying degrees may serve as imperfect or less-imperfect substitutes for physically-delivered futures. According to Table 11 of the Proposal, out of 3,653 unique traders that exceeded spot-month position limits during a two year period, only 35 held spot-month cash-settled positions that would have exceeded the Proposal's higher cash-settled limit level. Because of this disparate regulatory treatment, spot-month positions in physically-delivered contracts would trigger costly regulatory restrictions at significantly lower thresholds. These restrictions, which would be borne by large spot-month position holders in physically-delivered futures contracts, include:

- Adjusting commercial risk-reducing trading practices to comply with new and significantly narrowed prescriptive hedging exemptions;

- Satisfying costly reporting requirements that are placed on the shoulders of bona fide hedgers; and

- As further discussed in section VI and CME Group's comment letter on the "Aggregation of Positions" notice of proposed rulemaking, dated February 10, 2014, complying with account aggregation rules that would require enterprise-wide aggregation of positions (and risk management, if an entity needs to claim a bona fide hedging exemption)—a radical departure from Commission rules that required the aggregation of positions based on the personal ownership of accounts or based on trading control (as opposed to imputed, corporate ownership-based control).

1. Significant liquidity may artificially shift to cash-settled markets under the Proposal's framework

Cumulatively, these policies would detrimentally affect liquidity in physically-delivered benchmark futures contracts and the integrity of their price discovery function. This was not and cannot be the intent of Congress. The table below summarizes data provided in Table 11 of the Proposal.[78] As the Proposal's data demonstrates, a substantial amount of spot-month liquidity generated by large traders could artificially be incentivized to shift from physically-delivered futures contracts to cash-settled that to varying degrees may serve as imperfect or less-imperfect substitutes for physically-delivered futures.

[78] *See* 78 Fed. Reg. at 75,731.

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The data below has been adjusted to exclude natural gas contracts, which currently are subject to higher spot-month limits, and agricultural contracts that do not have physically-delivered futures markets.

From TABLE 11 Position Limit Proposal—UNIQUE PERSONS OVER PERCENTAGES OF PROPOSED POSITION LIMIT LEVELS, JANUARY 1, 2011, TO DECEMBER 31, 2012		
Contract	**Over Spot Month Physical Delivery**	**Over Spot Month Cash Settled**
Legacy	**168**	**0**
Other Agricultural	**36**	**0**
Energy	**102**	**79**
Metals	**5**	**0**
Total	**311**	**79**

We urge the Commission to recognize that parity in regulatory treatment, including in the application of spot-month position limits, should be a guiding principle for imposing regulatory requirements on economically fungible products.

2. Physically-delivered benchmark futures contracts, especially in the spot month, provide unique economic value to commercial end-users and the price discovery process

The Commission should reject the Proposal's attempted re-engineering of U.S. commodities markets. There is nothing in CEA section 4a that justifies this attempt to re-engineer the commodity derivatives market in this manner. To the contrary, in CEA section 4a(a)(3)(B)(iv), Congress specifically directed the Commission to tread carefully and protect the price discovery function of underlying benchmark futures contracts when exercising its position limits authority.

The primary reason that physically-delivered futures contracts are preferred by many commercial end-users for price discovery and hedging is that the physical-delivery mechanism ensures that futures and physical market prices converge at expiration. This convergence is accomplished because a short futures position can actually become a sale of the underlying commodity at the futures price and a long futures position can become a purchase of the deliverable commodity. If futures and cash commodity markets diverge, the actual deliverable commodity can be marketed to bring equilibrium to a market through "convergence trades." A convergence trade is described by the Proposal as follows:

> [T]he Commission has observed when a physical-delivery contract is trading at a price above prevailing cash market prices, commercials with inventory tend to sell contracts with the intent of making delivery, causing physical-delivery prices to converge to cash market prices. Similarly, the Commission has observed when a physical-delivery contract is trading at a price below prevailing cash market prices, commercials with a need for the commodity or merchants active in the cash market tend to buy the contract with the intent of taking delivery, causing physical-delivery prices to converge to cash market prices.

A well-constructed and liquid physical-delivery futures contract therefore facilitates price convergence through readily enabling convergence trades. However, unwarranted regulatory restrictions and inducements, such as those introduced by the Proposal, can reduce liquidity in physically-delivered

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futures contracts by artificially increasing capacity costs and the ability and willingness of traders to execute convergence trades. Unlike physical-delivery futures contracts, cash-settled contracts can only approximate convergence via mathematical formulas and theoretical prices that can fuel an arbitrage trade between the futures and cash markets. But because they have no ability to serve as substitutes for a physical commodity position, they are less likely to converge with the cash market. The Proposal's framework of penalties and incentives, which is designed to reduce liquidity in physically-delivered futures contracts, will also result in the artificial allocation of liquidity and price discovery to cash-settled contracts.

A cascade of negative consequences can follow from this misallocation. When liquidity and price discovery migrate away from a physical-delivery contract and to a related cash-settled substitute, the physical-delivery contract's convergence mechanism is weakened by the reduction in the expected volume of convergence trades. Weaker convergence, and concomitant increases in basis risk, particularly during episodes of sudden, exogenous shocks to the market due to weather, damage to infrastructure, government fiat or other factors, reduces the economic utility of a benchmark futures contract, further exacerbating basis risk. This cascade of negative consequences that can flow from artificially induced misallocations of liquidity can reduce hedger participation in benchmark futures and increase the influence of pure speculators in the price formation process. A market driven by pure speculation with little or no futures-cash arbitrage is more susceptible to narrative-driven, herd-like trading behavior, and more readily susceptible to manipulation. For these reasons, we urge the Commission to not accept the Proposal's framework, and reject its designed misallocation of liquidity to cash-settled markets.

C. The Proposal should not apply higher spot-month limits ("five times limits") to cash-settled contracts

Proposed rule 150.3(c) includes a conditional spot-month position limit for cash-settled contracts that would be set at a level up to five times, or at 125% of, the estimated supply that is deliverable under a physically-delivered futures contract (such limit is referred to herein as a "five times limit"). This five times limit, however, would only be available to traders that exit or do not establish spot-month positions in a related physically-delivered referenced contract, regardless of whether such physically-delivered positions would be speculative or bona fide hedges of commercial risk.[79] Incongruously, a trader qualifying for the five times limit could still hold an unlimited amount of the actual physical commodity. The Proposal would make the five times limits available across all 28 referenced commodity markets, including agricultural commodity markets.

The Proposal's recommendation to increase the spot-month limit for cash-settled contracts to 125% of deliverable supply, as one of several unsupportable conditions or requirements that cumulatively would reshape market structure, has policy and legal flaws that compel its rejection. First, the Proposal would replace a spot-month limit system of parity among physically-delivered and cash-settled contracts—a system the CFTC endorsed just two years ago—without citing any deficiencies in the operation of that system or providing any reasonable explanation of why the Proposal recommends the change, a fundamental legal error under the APA. Second, the five times limit purports to be based on an

[79] *See* Proposed rule 150.3(c).

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examination of data that is mentioned but not revealed thus precluding public commenters from evaluating such data and offering meaningful comment, a fundamental legal error under the APA. Moreover, the natural gas market data submitted as part of the CFTC's prior position limit rulemaking would not justify five times limits across all referenced commodity markets under the restrictive conditions that would be established by the Proposal's novel framework. Third, the CFTC's five times spot-month limit proposal vitiates all of the statutory touchstones Congress set out to be met by any position limit proposal by:

- Increasing the threat of price manipulation;
- Preventing physical delivery markets from serving the price discovery functions they have long provided and which Congress plainly sought to preserve;
- Enhancing the risk that cash-settled markets would face the congressionally-feared burdens of excessive speculation while eliminating speculation in physical delivery contracts that has not been shown to be excessive or harmful in any way; and
- Purposefully removing essential market liquidity for and thereby imposing higher costs on hedgers.

CME Group urges the CFTC to discard the five times spot-month limit proposal in light of the legal and policy flaws described in greater depth below. Instead of pursuing this illogical and detrimental proposal, the Commission should only consider spot-month limits for physical-delivery and cash-settled contracts that remain in parity—an approach that has served futures markets well for decades.[80] As discussed above in section II.A., we also urge the Commission to use accurate and up-to-date estimates of deliverable supply in imposing any equivalent spot-month limits after finding that such limits are necessary. We believe that spot-month limit levels based on an accurate and up-to-date estimate of deliverable supply would be adequate to accommodate any cash-settled spot-month liquidity requirement that otherwise would be constrained by parity spot-month limits based on lower levels. Accordingly, one artificial justification for adopting the higher, five times spot-month limit levels for cash-settled contracts would be addressed.

1. There is no reason to depart from equivalent spot-month limits for physically-delivered and cash-settled contracts as such limits have served futures markets well for decades; spot-month limit parity should be the approach for all commodities, including natural gas

[80] In opposing the CFTC's proposed five times limit for all commodities, including natural gas, CME Group acknowledges that CME currently lists a cash-settled natural gas contract that utilizes a five times limit. That limit was adopted and implemented in response to our competitors and not because we believed it represented sound regulatory policy that should apply across the board to all physical commodities. We have long believed and continue to believe that spot-month limit parity among physically-delivered and cash-settled contracts in the same commodity is the proper policy for all of the reasons set forth in this section II.C. of this letter.

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Spot-month limits for physically-delivered and cash-settled contracts that are in parity have demonstrably served futures markets capably. Indeed, there have been no major spot-month disruptions like the Hunt Brothers' activities in the silver market since the widespread utilization of cash-settled look-a-like futures contracts. Twenty seven of the 28 commodity markets referenced by the Proposal, and the hundreds of cash-settled referenced contracts that are linked to them through their price, continue to trade under spot-month position limits that are in parity.

In 2011, the Commission proposed a spot-month conditional limit rule nearly identical to the one contained in the Proposal.[81] However, the Commission's final 2011 rules adopted, with natural gas referenced contracts as an exception, spot-month position limits for cash-settled and physically-delivered futures contracts that remained in parity, in line with limits that "staff has historically deemed acceptable for cash-settled contracts and physically-delivered contracts under Acceptable Practices for Core Principle 5 in part 38."[82] These Acceptable Practices, which would use estimated deliverable supply to derive the same spot-month limit level for physically-delivered and cash-settled contracts,[83] reflect a simple notion: like contracts should be accorded the same regulatory treatment to prevent artificial distortions from allocating one market's liquidity to another.

In its final 2011 rules, the Commission affirmed that "parity should exist in all position limits (including spot-month limits) between physical-delivery and cash-settled Referenced Contracts (other than in natural gas); otherwise, these limits would permit larger positions in look-a-like cash-settled contracts that may provide an incentive to manipulate and undermine price discovery in the underlying physical-delivery futures contract."[84] Consequently, the Commission adopted an expanded limit only with respect to cash-settled contracts pricing natural gas for delivery at the Henry Hub, but without inflexibly conditioning the use of the expanded limit on exiting or not establishing positions in a related physically-delivered futures contract. The Commission concluded that "the one-to-one ratio (between the level of spot-month limits on physical-delivery contracts and the level of spot-month limits on cash-settled contracts in agricultural, metals, and energy commodities other than natural gas) maximizes the objectives enumerated in section 4a(a)(3)."[85]

With no reasoned basis, the Proposal now recommends five times spot-month limits for all referenced commodity markets, with the restrictive condition that the use of the expanded cash-settled spot-month limits be available only to traders that exit or do not establish positions in a related physically-delivered referenced contract. The Proposal arbitrarily dismisses its long-standing endorsement of spot-month limits that remained in parity in favor of five times limits for cash-settled contracts for all referenced commodity markets with a single flippant sentence:

> In proposing to expand the scope of derivatives contracts for which the conditional spot-month limit is available, the Commission has reconsidered the risks to the market of permitting a

[81] Proposed rule 151.4(a)(2), 76 Fed. Reg. 4572 (Jan. 26, 2011).

[82] 76 Fed. Reg. at 71,636.

[83] Vacated rule 151.4(a).

[84] 76 Fed. Reg. at 71,635.

[85] *Id.*

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speculative trader to hold an expanded position in a cash-settled contract when that speculative trader also is active in the underlying physical-delivery contract.[86]

The above sentence does not make clear what risks the Proposal has "reconsidered." Elsewhere, the Proposal alludes to being concerned that, if a trader has a leveraged cash-settled contract position, there is an increased risk of the trader "banging the close" in the physical delivery market to benefit the cash-settled contract position.[87] The Proposal thus recommends prohibiting a trader who holds an expanded cash-settled contract position pursuant to the five times limit from "also holding any position in the physical-delivery contract."[88] In effect, the Proposal has both manufactured a problem and invented a solution that is rife with its own serious policy problems as discussed below. The Proposal offers no evidence of a rash of "banging the close" cases in physical delivery contracts and no basis for assuming that DCMs cannot adequate police such misconduct. Moreover, the incentive identified by the Proposal for engaging in such misconduct—that is, having a leveraged cash-settled contract position—would not exist but for the Proposal's five times limit. In short, the Proposal does not provide a reasoned basis for its five time limits recommendation when spot-month limits that remain in parity have demonstrably served futures markets capably.

CME Group believes that the adverse policy consequences it identifies below as flowing from the CFTC's proposed five times limit policy (*i.e.*, increased threat of manipulation, compromised and fragmented price discovery, perceived burdens of excessive speculation, and higher costs for hedgers) would apply with equal force to a CFTC five times limit policy in the natural gas market, which currently is the only market with an exception to spot-month limit parity. That cash-settled contracts in natural gas should be given the same regulatory treatment as physically-delivered contracts—rather than favored through five times limits—is further supported by the Commission's own findings. In the Commission's October 2007 "Report on the Oversight of Trading on Regulated Futures Exchanges and Exempt Commercial Markets," the Commission stated that the NYMEX physically-delivered natural gas futures contract was "economically equivalent" to the ICE cash-settled natural gas contract (i.e., ICE Henry Financial LD1 Fixed Price Contract), that the NYMEX physically-delivered and ICE cash-settled contracts "essentially comprise a single market for natural gas derivatives trading," and that "traders look to both ICE and the NYMEX when determining where to execute a trade at the best price."[89] In other words, the Commission has recognized that the physically-delivered and cash-settled contracts in natural gas form a

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[86] 78 Fed. Reg. at 75,737.

[87] *Id.* at 75,736.

[88] *Id.*

[89] The Commission also observed that the "prices on the ICE and NYMEX contracts have an ongoing, linked relationship that extends not only to the linked settlement price but to prices between the two contracts throughout the trading day." *See* Order Finding That the ICE Henry Financial LD1 Fixed Price Contract Traded on the IntercontinentalExchange, Inc., Performs a Significant Price Discovery Function, 74 Fed. Reg. 37988, 37989-90 (July 30, 2009) (emphasis added); *see also* Jeffrey H. Harris, Commodity Futures Trading Commission, Chief Economist, Testimony at Hearing to Examine Trading on Regulated Exchanges and Exempt Commercial Markets (Sept. 18, 2007), http://www.cftc.gov/ucm/groups/public/@newsroom/documents/speechandtestimony/opaharris_091807.pdf (referring to economic data showing that the NYMEX physically-delivered natural gas futures contract and the ICE cash-settled natural gas contract each serve a price-leading function from time to time).

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linked market where the same market fundamentals influence the decisions of market participants and where arbitrage is commonplace. Thus, as discussed further below, if the Commission implemented five times limits for natural gas cash-settled contracts instead of using equivalent spot-month limits, any price distortions created by speculators taking advantage of those higher limits (let alone by speculators holding an expanded natural gas cash-settled contract position *and* unlimited cash market holdings in natural gas as would be permitted under the Proposal) would necessarily be transmitted through arbitrage to the natural gas physical delivery market, thereby disrupting the price discovery function of the physical delivery market.

Given that the CFTC's five times limit proposal would be detrimental for all commodity markets, including natural gas, the CFTC should not turn the natural gas exception to the rule of spot-month limit parity into a five times limit rule. CME Group maintains that ***all*** referenced commodity markets should be subject to equivalent spot-month limits for physically-delivered and cash-settled contracts, provided that the CFTC first determines that imposing spot-month limits is necessary and appropriate.

2. In violation of the APA, the Proposal fails to disclose to the public all of the data it examined in proposing its five times limits, and the data it does identify offers no support for the five times limits

The Proposal claims to have "examined market data on the effectiveness of conditional spot-month limits for cash-settled energy futures swaps, including the data submitted as part of the prior position limits rulemaking."[90] However, aside from identifying in a footnote "the data submitted as a part of the prior position limits rulemaking," the Proposal does not disclose the market data that it claims to have examined. The following sections discuss how the Commission's failure to disclose market data it relied on violates the APA and how the data that is identified does not support the five times spot-month limit proposal.

a) The CFTC has precluded an opportunity for meaningful comment on its five times limit proposal by withholding data purportedly underlying that proposal

Under the APA's notice-and-comment requirements, an agency's notice of proposed rulemaking "must disclose in detail the thinking that has animated the form of a proposed rule and *the data upon which that rule is based*."[91] More specifically, "among the information that must be revealed for public evaluation are the 'technical studies and data' upon which the agency relies in its rulemaking."[92] Here, the Commission has failed to abide by the APA's notice-and-comment requirements because it did not

[90] 78 Fed. Reg. at 75,737.

[91] *Home Box Office*, *Inc. v. FCC*, 567 F.2d 9, 35 (D.C. Cir. 1977).

[92] *Am. Radio Relay League, Inc. v. FCC*, 524 F.3d 227, 236 (D.C. Cir. 2008) (quoting *Chamber of Commerce v. SEC*, 443 F.3d 890, 899 (D.C. Cir. 2006)); *see also Solite Corp. v. EPA*, 952 F.2d 473, 484 (D.C. Cir. 1991) (citing *Connecticut Light & Power Co. v. NRC*, 673 F.2d 525, 530-31 (D.C. Cir. 1982) ("integral to the notice requirement is the agency's duty 'to identify and make available technical studies and data that it has employed in reaching the decisions to propose particular rules. . . . An agency commits serious procedural error when it fails to reveal portions of the technical basis for the proposed rule in time to allow for meaningful commentary'")).

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make available to the public all the market data it relied on for its five times spot-month limit proposal. Rather, the Commission's Proposal merely stated that the Commission "examined market data on the effectiveness of conditional spot-month limits for cash-settled energy futures swaps" and that "data submitted as part of the prior position limits rulemaking" was "include[d]" in the broader category of market data the Commission purportedly examined.[93] As a result of the Commission's withholding of market data, the public has been deprived of a meaningful opportunity to comment on that data and the Commission's five times spot-month limits proposal.

b) The data submitted as part of the CFTC's prior position limits rulemaking cannot reasonably be used to support five times limits for all commodity markets

In proposing the five times limits, the Commission relies on "data submitted as part of the prior position limits rulemaking." That data is identified in a footnote as "data for the CME natural gas contract" that was discussed in the CFTC's final vacated rulemaking.[94] As a threshold matter, such data related to the Henry Hub natural gas market cannot justify universal five times limits because the Henry Hub market is an outlier among the Proposal's referenced commodity markets. The Commission itself acknowledged as much in its 2011 final vacated rules, stating that it had "a reasonable basis to believe that the cash-settled market in natural gas is sufficiently different from the cash-settled markets in other physical commodities to warrant a different spot-month limit methodology."[95] The Commission reasoned that natural gas has "very active cash-settled markets both at DCMs and exempt commercial markets"[96] and observed that this liquidity persisted through the spot month. In addition, the Commission found that no other referenced contract market had comparable levels of cash-settled contract liquidity relative to the relevant physically-delivered futures contract.[97] The Commission's final vacated rules thus did not rely on data or market characteristics pertaining to the natural gas market to develop spot-month limit rules for other commodity markets. Similarly, the Commission here should have recognized that it cannot reasonably use information relating to the natural gas market to extend a five times spot-month limit policy to all referenced contract commodity markets.

Furthermore, "the data submitted as part of the prior position limits rulemaking" cannot reasonably be used as support for the Commission's proposed five times spot-month limit policy because that data related to Henry Hub natural gas conditional limits that are in fact substantively different from, and overall not as restrictive as, the Proposal's version of conditional limits. For example, the current natural gas conditional limit framework does not prohibit a trader from holding NG options (symbol ON) that can, if exercised, become NG futures contract positions. In addition, under the current conditional limits framework, a trader can hold up to the NG spot-month limit (1,000 contracts) while holding up to the spot-month limit positions in NYMEX (symbol NN) and ICE (symbol HH) contracts as well (for a total

[93] 78 Fed. Reg. at 75,737.

[94] *Id.* at 75,737 n.459.

[95] 76 Fed. Reg. at 71,635.

[96] *Id.*

[97] *Id.* at 71,634-71,635.

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position 3 times the spot-month limit or 3,000 contracts) in addition to an unrestricted OTC position. In contrast, under the Proposal's version of conditional limits, the choice for traders is: (1) a position up to 1,000 contracts in NG and 1,000 contracts in all cash-settled contracts (for a total of 2,000 contracts) or (2) an aggregate position up to five times the limit in NYMEX and ICE cash-settled contracts but with no positions in the NG contract or options thereon (for a total position of 5,000 contracts).

The current conditional limits framework and the Proposal's version of conditional limits also differ in terms of treatment of cash commodity positions. Whereas traders claiming the current conditional limits in natural gas cannot hold large cash commodity positions, traders claiming the CFTC's proposed five times limits can hold unlimited cash commodity positions. As discussed below, the ability to hold an unlimited amount of a cash commodity under the CFTC's five times limit proposal would increase the risk of manipulation. Instead of fully recognizing the differences between the current natural gas conditional limits framework and the CFTC's proposed five times limit policy and analyzing the implications of those differences, the Proposal has blindly and unreasonably relied on data relating to the current conditional limits in natural gas as support for the adoption of its proposed five times limits.

3. The CFTC's proposed five times limits would undermine, not serve, the CEA section 4a(a)(3) regulatory objectives

Under CEA section 4a(a)(3), the CFTC is obligated to ensure that any limits it sets, to the maximum extent practicable, serve the following regulatory objectives: (1) diminish, eliminate, or prevent excessive speculation as described under Section 4a(a)(1); (2) deter and prevent market manipulation, squeezes, and corners; (3) ensure sufficient market liquidity for bona fide hedgers; and (4) ensure that the price discovery function of the underlying market is not disrupted. In its Proposal, the Commission states that it "preliminarily believes that the [five times limit] approach effectively addresses the § 4a(a)(3) regulatory objectives."[98] As shown below, the Commission's "preliminary belief" is incorrect; the five times limit approach would actually undermine each of the regulatory objectives in CEA section 4a(a)(3).

a) The five times limits would increase the potential for manipulation

CME Group is concerned that the Proposal's five times limits provide a blueprint for manipulation of a commodity market. A manipulative scheme involving physical commodities has two general components: the manipulating instrument (generally the physical-delivery futures contract or the cash market) and the "position-to-benefit" (generally a large directional derivatives position). The "manipulating instrument" in a cornering of a commodity market is the cash market commodity. The position-to-benefit is the position that benefits from the manipulation. In a successful cornering,[99] a market participant likely loses money accumulating increasingly expensive and scarce cash commodity,

[98] 78 Fed. Reg. at 75,737.

[99] A party is said to "corner" a market when it has a net long position and owns all or substantially all of the deliverable supply of a particular commodity. *See Cargill, Inc. v. Hardin*, 452 F.2d at 1161-62 (8th Cir. 1971); *Great Western Food Distributors, Inc. v. Brannan*, 201 F.2d 476, 478-79 (7th Cir. 1953), cert. denied, 345 U.S. 997, 73 S.Ct. 1140, 97 L.Ed. 1404 (1953).

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but makes more than enough to recoup these losses and more from a large, leveraged derivatives position-to-benefit.

The proposed five times limit regime would allow a trader to hold up to 125% of deliverable supply in cash-settled referenced contracts. A leveraged position equal to 125% of deliverable supply creates an enormous incentive for a bad actor to manipulate the cash market or to collude with another person who can manipulate the cash and physical-delivery futures market ("cash market colluder") while the holder of the large position-to-benefit reaps the rewards ("derivatives position holder"). In this scenario, the cash market colluder's ability to manipulate the cash market and physical-delivery futures is enhanced as liquidity in the physical-delivery futures contract is diminished. In turn, as liquidity in the physical-delivery futures market decreases, so does liquidity in the cash market as the arbitrage trade that fuels liquidity in both markets is suppressed. At the same time, as liquidity moves to cash-settled contracts, the ability of the derivatives position holder to accumulate this position in cash-settled contracts is enhanced as it can obtain that position without exhausting liquidity and therefore at a competitive price. The ability to obtain a position-to-benefit at a price that does not include a liquidity cost further improves the economics of manipulation.

In contrast, when spot-month limits are maintained at parity, the maximum speculative directional position-to-benefit a trader could build is equivalent to 50% of deliverable supply. The effective use of limits that remain in parity over the course of decades indicates that positions at such levels, comprised of both physically-delivered and cash-settled contracts, strike the right balance between preventing manipulative conduct and ensuring sufficient liquidity for bona fide hedgers.

The Commission has been aware of the increased incentive to engage in manipulative conduct that may flow from five times spot-month limits for cash-settled contracts. In its final 2011 rules, the Commission cited concerns about the increased incentive to engage in manipulative conduct created by five times spot-month limits.[100] In its 2011 proposal, it sought to address this concern by requiring that a trader claiming a five times limit hold physical commodity inventory of less than or equal to 25% of estimated deliverable supply.[101] In 2013, the Proposal seeks to replace that requirement with enhanced reporting requirements. These enhanced reporting requirements, however, only extend to a trader claiming the five times limit for natural gas cash-settled contracts.[102] Thus, the reporting requirements would not increase surveillance over manipulative cash market activities in commodities beyond natural gas. The extent to which the requirements would be helpful in detecting manipulation in the natural gas market is also questionable given that the requirements would apply to a trader claiming the five times limit and thus cash market colluders would go undetected.

By increasing the risk of manipulation of the cash commodity market in order to benefit a leveraged cash-settled contract position, the Proposal's five times spot-month limit proposal would also increase the risk that physical delivery contract prices will be distorted. Simply put, physical delivery contract

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[100] Five times limits "may provide an incentive to manipulate and undermine price discovery in the underlying physical-delivery futures contract." 76 Fed. Reg. at 71,635.

[101] *See* 76 Fed. Reg. at 4758.

[102] *See* proposed rule 19.01(b).

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markets are linked to look-a-like cash-settled contract markets so that—through arbitrage between the markets—any price distortion or artificial price experienced in the cash-settled contract will necessarily be transmitted to the related physical delivery contract. Thus, although a trader claiming the five times limit would not be able to establish physical delivery contract positions and thus could not "attempt to mark the close or distort physical-delivery prices" in a direct manner, that trader would still be able to distort physical delivery contract prices by manipulating the linked cash-settled contract prices or otherwise creating a price distortion in such cash-settled contract prices (e.g., through cornering the cash commodity market to benefit the cash-settled contract price). The Commission fails to recognize that its proposal would not only increase the risk of a cash market manipulation, but would also increase the risk of price distortions in the physical delivery market.

b) <u>The five times limits would disrupt price discovery in physically-delivered futures contracts</u>

In promulgating position limits rules under section 4a(a)(2) of the Act, the Commission is required to consider Six Safeguards in determining whether any position limits rules it seeks to impose are appropriate, as discussed above in section I.B.2. Two of these Six Safeguards relate to price discovery: the Commission must ensure that the position limits it imposes do not "disrupt the price discovery function of the underlying market"[103] or "cause price discovery in the commodity to shift to trading on the foreign boards of trade"[104] ("Price Discovery Safeguards").

The Proposal consistently circumvents addressing these statutory Price Discovery Safeguards with a sleight of hand that conflates them with manipulation or excessive speculation. For example, the Proposal concludes that its five times limits would not disrupt the price discovery function "in a way that would make the physical-delivery contract more susceptible to sudden price movements near expiration."[105] Similarly, the Proposal states that five times limits would be effective at "protecting the price discovery process in the physical-delivery contract from the risk that traders with leveraged positions in cash-settled contracts (in comparison to the level of the limit in the physical-delivery contract) would otherwise attempt to mark the close or distort physical-delivery prices to benefit their leveraged cash-settled positions."[106]

These arguments, however, miss the mark in considering the five times limit's effects on the price discovery function of the physical delivery futures market. The Proposal concedes that its five times limits would "eliminate all speculation" in a physically-delivered contract's spot month by market participants that would be trading financial look-a-likes pursuant to the five times limit. In other words, the Proposal's five times limit is designed to include an artificial incentive for liquidity, both speculative and commercial, to migrate from physical-delivery contracts to financial look-a-likes. This is in direct

[103] CEA section 4a(a)(3)(B)(iv); 7 U.S.C. § 6a(a)(3)(B)(iv). "Underlying market" refers to the "underlying" benchmark physical-delivery futures contract to which "economically-equivalent" and "significant price discovery function" swaps and FBOT contracts relate.

[104] CEA section 4a(a)(2)(C); 7 U.S.C. § 6a(a)(2)(C).

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

[106] *Id.*

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opposition to the Congressional concern that the Commission refrain from disrupting the price discovery function of the underlying market, or potentially cause price discovery to shift to trading on foreign markets. The Proposal's failure to appropriately consider the effect of five times limits, alone or as a constituent part of an overall proposed regulatory framework, on the Act's Price Discovery Safeguards is sufficient reason for the Commission to not adopt the Proposal's five times limit rules.

c) The five times limits would promote excessive speculation in the cash-settled contract while eliminating speculation from the physically-delivered contract that is not excessive

The Proposal's five times limit demonstrates a fundamental misunderstanding of CEA Section 4a(a)'s objective of combatting "excessive speculation as described under [Section 4a(a)(1)]." Section 4a(a)(1) refers to "excessive speculation" that causes "sudden or unreasonable fluctuations or unwarranted changes in the price of [a] commodity."[107] By allowing for an expanded, five times spot-month speculative limit in cash-settled contracts, the Proposal increases the risk that cash-settled markets will face the Congressionally-feared burdens of excessive speculation—i.e., "sudden or unreasonable fluctuations or unwarranted changes in the price of [a] commodity." Indeed, the Commission itself acknowledged in its Proposal that "[s]udden or unreasonable fluctuations or unwarranted changes in the price of a commodity derivative contract may be caused by a trader establishing, maintaining or liquidating an *extraordinarily large position whether in a physical-delivery or cash-settled contract.*"[108] With respect to physically-delivered referenced contracts, in contrast, the Commission's five times spot-month limit proposal is designed inexplicably to eliminate *all* speculation in such contracts during the spot month by traders transacting under a conditional limit. Contrary to the plain text of CEA Section 4a(a)(3), the Proposal treats as "excessive speculation" *any* speculation in the spot period of the physically-delivered referenced contract by "a trader availing herself of the conditional spot month limit exemption."

The Proposal has failed to show how "eliminating all speculation" in the physical delivery contract by some traders will somehow prevent the burdens of "excessive speculation"—i.e., "sudden or unreasonable fluctuations or unwarranted changes in the price of [a] commodity." Ironically, eliminating speculation in the physical delivery markets, and hence causing liquidity to shift to cash-settled markets, is precisely what can cause "sudden or unreasonable" fluctuations of prices in physical delivery markets. The following quote from the Proposal describes a scenario whereby a trader seeks to establish a large position in an illiquid market and there is a resulting "unwarranted price fluctuation."

> A trader that demands immediacy in establishing a long position larger than the amount of pending offers to sell by market participants may cause the commodity derivative contract price to increase, as market participants may demand a higher price when entering new offers to sell. It follows that an extraordinarily large position, relative to the size of other participants' positions, may cause an unwarranted price fluctuation.[109]

[107] CEA section 4a(a)(1); 7 U.S.C. § 6a(a)(1).

[108] 78 Fed. Reg. at 75,688 (emphasis added).

[109] *Id.*

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In the above example, more liquidity[110] in the market would have reduced the risk of an "unwarranted price fluctuation." Because "speculation is often an important contributing factor to market liquidity and pricing efficiency," as speculation increases, liquidity increases, and the risk of the harms from "excessive speculation" decreases.

The reason why the Proposal would drastically reduce participation (and hence liquidity) in physically-delivered contracts is clearly illustrated with a simple example: a trader has two choices under the Proposal's framework—cap a speculative derivatives position at two times the physically-delivered contract limit with half of the position in the physically-delivered contract, or at five times the physically-delivered contract limit but with no position in the physically-delivered contract. In contrast, spot-month limits that maintain parity would create no artificial incentives for liquidity to migrate to cash-settled contracts and would therefore be more effective at reducing "sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity" in physically-delivered futures markets.

d) The five times limits would have serious negative effects on liquidity for bona fide hedgers

Section 4a(a)(3)(B)(iii) of the Act requires that the Commission, in establishing position limits under section 4a(a)(2) of the Act, to the maximum extent practicable, in its discretion, "ensure sufficient liquidity for bona fide hedgers." Under section 4a(c)(2) of the Act, a "bona fide hedging transaction or position" is one that, among other things, "represents a substitute for positions taken or to be taken at a later time in the physical marketing channel."

There is no clearer example of this than a hedge position that satisfies a need for a physical commodity, such as a long physical-delivery futures hedge position of anticipated requirements. A producer using this hedge, even if it may not specifically intend to utilize the physical-delivery futures contract's commodity, obtains valuable optionality from the fact that the cash market position the physical-delivery futures position expires into is a substitute for cash market transactions that do satisfy a physical commodity need.

For example, a utility located in Illinois may not intend to take delivery of natural gas at Henry Hub in Louisiana for power production purposes. However, the settlement optionality provided by a NYMEX NG contract position enables the utility to either (i) take delivery on the gas if at expiration the Henry Hub natural gas plus the transportation cost to Illinois is lower than Illinois spot natural gas, (ii) take delivery on the gas at expiration and then exchange gas at Henry Hub for gas at the needed delivery location, or (iii) liquidate the hedge position before expiration. This optionality makes the physical-delivery contract more valuable to commercial end-users. In general, this optionality, and the bona fide hedging it encourages in the physically-delivered futures contract, improves futures-cash market convergence.

[110] Liquidity" is defined by the Commission as "a broad concept that captures the ability to transact immediately with little or no price concession." 74 Fed. Reg. 12,178, 12,179 (Mar. 23, 2009).

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A bona fide hedger seeking to establish a hedge position depends on market liquidity in order to execute the hedge transaction without incurring a price concession to induce a trade. The Proposal readily states that its five times limits would by design "eliminat[e] all speculation" in physically-delivered contracts by those who prefer a larger overall cash-settled speculative position using five times limits. These large speculative traders, however, are precisely those whose large position appetite can absorb the demand for liquidity from bona fide hedgers, enabling them to transact at competitive prices. What a large speculator's liquidity provides a hedger is the ability to immediately transact at a competitive price whether or not the immediate speculative counterparty intends to make delivery on the resulting futures contract position. While ultimately cash market transactions are undertaken by commercial producers, consumers, and physical commodity merchants, speculators provide needed persistent liquidity to these commercial market participants to help them transact without a price concession. As stated concisely by the CFTC's Deputy Director for Market Surveillance, Matthew Hunter: "speculators allow producers and consumers to meet across time."[111]

Bona fide hedgers with a need for the commodity underlying the physical-delivery futures contract would be particularly affected by the Proposal's five times limits. Under the Proposal, even a bona fide hedge position in the physically-delivered futures contract would render a company ineligible for the higher five times cash-settled speculative position limit. Large hedgers would therefore have an incentive to hedge in cash-settled contracts. The loss of bona fide hedgers with the ability to exercise the optionality to make or take delivery on the physically-delivered contract, in addition to large speculators, would make it more difficult for those hedgers with a need for a physical-delivery commodity to find counterparties at a competitive price. In so doing, the Proposal's five times limits creates additional artificial and unwarranted incentives that run counter to the goal set by Congress in section 4a(a)(3)(B)(iii) of the Act: to ensure sufficient liquidity for bona fide hedgers. In contrast to the Proposal's five times limits, equivalent spot-month limits for physical-delivery and cash-settled contracts do not create artificial incentives that can misallocate liquidity from one market to another to the detriment of hedgers.

4. The Proposal's alternatives to five times limits all have the same basic failings as five times limits

The Proposal perhaps recognizes that its five times limit rests on shaky ground and therefore shifts to Advance Notice of Proposed Rulemaking mode by raising three alternatives and four additional policy questions. We have feathered answers to the questions into the bulk of our letter in various places, but it is notable that in these questions the Proposal turns the CEA and APA on their heads to ask commentators whether a "particular product" raises special issues.[112] This line of questions would be greatly aided if the Proposal had followed the statute and considered its limits and the accompanying justification on a "particular product" basis. Having deliberately failed to do so, it is more than ironic that the Proposal believed it was appropriate to ask commentators to offer a particular product analysis.

[111] Speculation, Michael Cosgrove, https://www.bauer.uh.edu/centers/uhgemi/documents/Michael%20Cosgrove.doc (quoting Matthew Hunter, CFTC Deputy Director for Market Surveillance)

[112] *See* 78 Fed. Reg. at 75,738.

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At this stage of the rulemaking, all we can say is that CME Group disagrees with the Proposal's apparent view that all physical commodities are the same and should be treated the same.

The three Alternatives suggested by the Proposal[113] raise many of the same issues as the five times limit, as well as some new ones. For clarity, each of the Alternatives is summarized as follows:

Alternative #1 would allow traders to enjoy a five times limit in a cash-settled contract so long as the contract settles to an index based on cash-market transactions. Traders with even a single position in the physically-delivered contract or a cash-settled contract that settles off the physically-delivered contract would be ineligible for the five times limit.

Alternative #2 would allow traders to enjoy a five times limit in a cash-settled contract even if the traders held positions in the physically-delivered contract. While not clear from the description, apparently, under the alternative, a trader could have a position at 25% deliverable supply in the physically-delivered contract and a position at 125% deliverable supply in the related cash-settled contract.

Alternative #3 seems to combine elements of Alternatives #1 and #2: it would allow traders to enjoy a five times limit in cash-settled contracts that settle off an index based on cash-market transactions; a trader could also hold positions in cash-settled contracts that settle to the underlying physical-delivery contract provided that the trader not exceed a spot-month limit set at the same level as that of the physical-delivery contract. The trader, however, would need to ensure that its overall cash-settled position does not exceed an aggregate five times limit. Thus, Alternative #3 would seem to allow a trader to hold positions at levels of 125% in cash-settled contracts and 25% in physically-delivered contracts. (It is hard to determine if that is precisely what the Proposal has in mind, which only further underscores the ANPR-like character of this portion of the Federal Register notice.)

CME Group opposes each of these Alternatives. Each could lead to pricing disparities among markets that could compromise seriously the spot-month convergence process. Each could lead to price distortions that would reverberate from cash-settled contracts to the physically-delivered contract through arbitrage. Each poses the real threat of cash market price manipulation as each assumes (apparently) that traders could hold unlimited amounts of the cash commodity. And each would undermine the price discovery process in the benchmark physically-delivered market, contrary to express Congressional direction not to do so.

Alternatives 1 (and possibly Alternative 3 if it does indeed condition a higher cash-settled limit on not holding positions in the physical delivery contract) are most curious for another reason. Apparently the Proposal fears "banging the close" mischief in the physically-delivered futures markets more than it fears similar mischief in cash market indexes. That is, the Proposal fears that more mischief is likely to occur in markets the Commission regulates than in the cash markets it does not. CME Group disagrees strongly with this premise. We police vigilantly against misconduct during the close on our markets and believe we have the market surveillance tools to ensure market integrity.

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[113] *See id.*

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Overall, like the Proposal, the Alternatives seem to be trying to find a way to establish a higher ceiling than the current DCM-set spot-month limits in order to enable commercial market participants to manage their risks more freely in the spot month without worrying about the new bona fide hedge or aggregation restrictions. The Commission should reject the Proposal and the Alternatives' attempt to provide for five times limits to accommodate detrimental narrow hedge exemptions that delegitimize accepted commercial risk reducing trading practices and novel aggregation standards that are not authorized by the Act and have never prior to 2011 been enunciated by the Commission. In other words, the Commission should recognize that the Proposal's "solutions," including the five times limit, are responses to problems manufactured by the Proposal itself.

As discussed above, CME Group believes that spot-month limit parity works well; no case has been made for changing that structure which should be applied to all commodities. To the extent that current market conditions warrant higher position limits, the proper way for the Commission to achieve that result is by first accepting updated deliverable supply estimates just as CME Group has suggested. Market participants should not be saddled with deliverable supply estimates from the last century, when current and accurate estimates are readily available today. Nor should the Commission make regulatory judgments in 2014 about markets and market impacts based on data that is decades old. Once the Commission has accepted updated deliverable estimates, CME Group would welcome a dialogue with the Commission on the appropriate higher spot-month levels.

III. The Commission should not accept the Proposal's non-spot-month position limits because they are arbitrarily and unduly restrictive and counterproductive to preventing "excessive speculation" or manipulation

A. The Proposal's non-spot-month position limit formula should rightly be withdrawn because it fails to appropriately consider CEA section 4a's Six Safeguards for each affected commodity

Proposed regulation 150.2(e)(4) uses the same "open interest formula" to determine single month and all months position limits ("non-spot-month position limits") regardless of the characteristics of a commodity market or contract.[114] The Commission first proposed the open interest formula in 1992 as the basis for new speculative position limit levels for "legacy" agricultural commodities subject to federal speculative position limits.[115] Crucially, it did not use the formula to automatically adjust limits for these commodities. In the same 1992 rulemaking, the Commission stated that the "fundamental tenet in the Commission's setting of speculative position limits is that such limits must 'be based upon the individual characteristics of a specific contract market.'"[116] The Commission also noted that "the

[114] The formula would set single-month and all-months position limits at 10% of open interest for the first 25,000 contracts in a referenced contract market and 2.5% thereafter. Proposed 150.2(e)(4).

[115] *See* Revision of Federal Speculative Position Limits, Proposed Rules, 57 Fed. Reg. 12,766 (Apr. 13, 1992).

[116] *Id.* at 12,770 citing 52 Fed. Reg. at 6,815.

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limits which are appropriate for certain types of commodities, such as agricultural commodities, may [not] be appropriate for other tangible or intangible commodities."[117] The Commission suggested different limits might be appropriate for non-agricultural commodities because of the "depth of the underlying cash market and ease of arbitrage [that] differ from agricultural markets."[118]

Notwithstanding the fact that the Commission did not find the open interest formula appropriate for 19 of 28 referenced contract commodities in 1992, the Commission now proposes to apply this formula to all 28 referenced contract commodities, and to 503 fundamentally varied futures, options, and listed swaps, and an unknown number of OTC swaps, regardless of the characteristics of each of the respective markets. The Proposal does not even attempt to explain an approach that is contradictory to the Commission's long-standing determinations.

In certain cases, the effect of the Proposal would be to reverse decades old Commission-approved position limits. For example, in 1993, the CME submitted rules lifting all-months-combined limits for its live cattle, live hogs, and feeder cattle contracts to the Commission for approval. When the Commission approved the submitted rules, it did so in response to CME's analysis of all-months-combined limits as applied to continuously-produced and non-storable commodities. In addition, the Commission approved CME's Milk futures contract submitted in May 1995 without an all-months-combined limit. While the Milk contract was initially specified with a physical-delivery settlement mechanism, shortly thereafter it was changed to cash settlement with only a single-month position limit.

As noted by CME in 1993, continuously produced non-storable commodity markets are fundamentally different than storable commodities.[119] Deliverable supplies at each expiration for non-storable commodities are independent from the previous expiration since the commodity cannot be stored and carried from one delivery period to the next. Therefore a reduction in the deliverable supply for the current delivery period does not lead to a reduction for all subsequent delivery periods.

Furthermore, prices of futures contracts for non-storable commodities, unlike certain storable commodities, are not linked across months by the cost of storage. Thus, a change in the futures price for one contract month does not necessarily lead to similar changes in the price of all subsequent contract months within a relevant period. For these reasons, the all-months-combined limits were deemed unnecessary by CME and the Commission, and the potential insignificant benefits of all month limits were outweighed by the likely cost of eroding speculative volume and liquidity, and thereby interfering with the efficient functioning of a non-storable commodity futures market.

The Proposal's arbitrarily inflexible non-spot-month position limits have no apparent relationship to deterring excessive speculation or manipulation. As demonstrated with non-storable commodities, the limits the Proposal sets forth would have widely different effects on different commodities, and there is no reason to believe that the proposed non-spot-month speculative position

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[117] *Id.*

[118] *Id.* at n. 14.

[119] CME Submission No. 93-25, Proposed Amendments to the Speculative Position Limit Provisions of the Chicago Mercantile Exchange's Live Cattle, Feeder Cattle, Live Hogs, and Pork Bellies Futures and Option Contracts.

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limit levels would curb excessive speculation or manipulation in the higher-impact markets. Table 11 to the Proposal shows that a total of 32 unique persons in CME Class III Milk, CME Feeder Cattle, CME Live Cattle and CME Lean Hogs would have been over the all-months limits that are being proposed for these products based on data from 2011 to 2012. This data indicates that imposing all-months-combined limits in these non-storable commodity markets would have a significant negative impact on the liquidity in these markets. Furthermore, in COMEX Copper referenced contracts, 16 unique traders would have been over the Proposal's deferred month speculative position limit levels based on their positions during 2011 to 2012. Likewise, for the same period, the number of unique traders with all-months-combined overages are 12 in COMEX Gold reference contracts, 9 in COMEX Silver reference contracts, 10 in NYMEX Platinum referenced contracts, 13 in NYMEX NY Harbor ULSD referenced contracts, and 18 in NYMEX RBOB Gasoline referenced contracts. In contrast, according to this analysis, no enterprises would have been affected in NYMEX Henry Hub Natural Gas. The Commission provides no explanation or observations that acknowledge these disparate impacts. In the absence of additional insight from the Commission, Table 11 indicates that the impact of the Commission's non-spot-month position limits is random and arbitrarily inflexible with no relationship to preventing excessive speculation or manipulation.

As discussed above in section I, CEA section 4a requires that the Commission consider each commodity individually in order to achieve an "appropriate" balance among CEA section 4a's Six Safeguards. Because the Proposal has not undertaken an analysis of the individual referenced contract commodity markets, its proposed non-spot-month position limits are categorically inappropriate. We therefore urge the Commission to withdraw its non-spot-month position limits because of the Proposal's circumvention of the requirement to appropriately address the Six Safeguards in proposing to exercise authority under section 4a of the Act to establish a position limits framework.

B. Amaranth's large speculative positions do not demonstrate that non-spot-month position limits are necessary

Position accountability rules are designed to curb excessive speculation and to prevent manipulation and are a more effective substitute for position limits. Position accountability rules replaced DCM-administered non-spot-month position limits first for financial futures in 1991[120] and for energy and metals futures in 1992.[121] In determining to allow DCMs to substitute position accountability rules, the Commission cited "its over ten-years of experience of overseeing the exchange-set speculative limits."[122] The Commission found that because energy and metals contracts "generally are characterized by a high degree of liquidity" and "have substantial forward markets that readily are

[120] Speculative Position Limits—Exemptions from Commission Rule 1.61, 56 Fed. Reg. 51,687 (Oct. 15, 1991).

[121] Speculative Position Limits— Exemptions from Commission Rule 1.61, 57 Fed. Reg. 29,064, 29,066 (June 30, 1992).

[122] *Id.*

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arbitraged with the futures [or] options," position accountability levels were adequate substitutes for non-spot-month position limits.[123]

Exceeding a position accountability level (which is established a lower level that the proposed position limits) subjects a trader to heightened scrutiny and oversight by a DCM. A DCM has the power to cap or require a reduction in a speculative trader's position held in excess of that. For example, under NYMEX rules:

> A person who holds or controls aggregate positions in excess of specified position accountability levels or in excess of position limits pursuant to an approved exemption shall be deemed to have consented, when so ordered by the Market Regulation Department, not to further increase the positions, to comply with any prospective limit which exceeds the size of the position owned or controlled, or to reduce any open position which exceeds position accountability or position limit levels.[124]

The Proposal argues that "had [its proposed non-spot-month position limits] been in effect in 2006, Amaranth would not have been able to build such large positions in natural gas futures and swaps and thereby limits would have restricted Amaranth's ability to cause harmful price effects that limits are intended to prevent."[125] The Proposal ignores the more targeted solution- position accountability rules. In early August 2006, NYMEX exercised its position accountability rules and capped Amaranth's large speculative positions. In response, "Amaranth traded natural gas on [the then unregulated InterContinental Exchange ("ICE") OTC platform] rather than NYMEX so that it could trade without any restrictions on the size of its positions."[126]

The flexibility of position accountability rules would have enabled an exchange to curb Amaranth's large speculative positions to a greater extent than non-spot-month position limits under the Commission's proposed formulation. Generally, the non-spot month accountability rules allow for earlier and more flexible intervention than position limits, potentially preventing harmful trading well in advance of the time a non-spot-month limit level is achieved. The lesson learned from Amaranth is not that position accountability rules are ineffective, it is that they were not in place where they should have been—in unregulated swaps markets like ICE. The Senate Permanent Sub-Committee on Investigations' Report on "Excessive Speculation in the Natural Gas Market" relating to Amaranth provided a key recommendation: swaps trading facilities like ICE should be subject to oversight like NYMEX and therefore required to impose position accountability levels to prevent the form of OTC arbitrage conducted by Amaranth.[127] Crucially, the report did not recommend imposing hard non-spot-month

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[123] *Id.* at 29,066-29,067.

[124] NYMEX Rulebook, Rule 560*, available at* http://www.cmegroup.com/rulebook/NYMEX/1/5.pdf.

[125] 78 Fed. Reg. at 75,693.

[126] Senate Permanent Sub-Committee on Investigations, *Excessive Speculation in the Natural Gas Market* at 6 (June 25, 2007)*, available at* https://www.levin.senate.gov/imo/media/doc/supporting/2007/PSI.Amaranth.062507.pdf.

[127] *Id.*

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limits.[128] Today, ICE OTC and all other swap trading facilities must register as "swap execution facilities" which are subject to a host of new rules, thus giving the Commission authority to impose position accountability rules on such markets.[129]

Non-spot-month position limits are therefore not necessary to address the excessive speculation or potential manipulation that is exemplified by Amaranth. Moreover, non-spot-month position limits are not necessary to prevent price fluctuations in instances where "a trader demands immediacy in establishing" a large position in liquid markets because liquid markets, as determined by the Commission in 1992, are resilient to such demands for liquidity. We note again that the existing alternative to position limit rules -- position accountability rules -- have been highly successful. Indeed, we are not aware of any instance, and the Commission has not referenced any instance in its rulemaking, in which position accountability rules were inadequate.

The Commission's proposed non-spot-month position limit levels are more harmful to liquidity and price discovery than a position accountability framework. This is because exceeding proposed non-spot-month position limits would require many non-speculative firms, such as commercial end-users, to either obtain exemptions and maintain the appropriate paperwork, or stay below the limit levels despite their bona fide hedging needs. Moreover, improperly calibrated non-spot-month limits would also deter speculative activity that triggers no risk of manipulation or "causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity;" the hallmarks of "excessive speculation."[130]

The CME Group has preliminarily reviewed the impact of the Proposal's requirements, including the impact of non-spot-month position limit levels on its markets. The CME Group has found that position limit overages disproportionately affect commercial entities. As discussed above, neither Amaranth nor the Hunt Brothers were commercial traders. Requiring entities with risk reducing trading practices to submit notice filings when their activities do not raise a threat of excessive speculation imposes unnecessary compliance costs—costs that are exacerbated by the fact that the Proposal's bona fide hedging exemption, as discussed below, is grossly at odds with how commercial firms manage their risks.

C. If the Commission nonetheless determines to impose non-spot-month position limits without considering whether they are appropriate for each commodity, then we recommend that the Commission impose them in a less harmful manner that is complementary with the existing position accountability regime so as to prevent inadvertent harm to the market

If the Commission determines to overlook compliance with its statutory and regulatory obligations to set position limits after a careful analysis with respect to each commodity as discussed

[128] *Id.*

[129] CEA section 1a(50) and 17 C.F.R. 37.600 ("To reduce the potential threat of market manipulation or congestion, especially during trading in the delivery month, a swap execution facility that is a trading facility shall adopt for each of the contracts of the facility, as is necessary and appropriate, position limitations or position accountability for speculators.").

[130] CEA section 4a(a)(1), 7 U.S.C. § 6a(a)(1).

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above, then the Commission should act in a manner less likely to be harmful to the markets. We would recommend, in this case, implementing non-spot-month position limits at levels that complement exchange position accountability rules. The Commission could do this by working cooperatively with the exchanges in setting non-spot-month limits at levels high enough to avoid having a damaging impact on the liquidity necessary to facilitate hedging activity. For example, such limits could be based on a 10, 5% of open interest formula in order to best ensure that hedging activities or price discovery are not negatively affected.

Furthermore, with respect to exchange-set limits or accountability rules, we note that our understanding of proposed rule 150.5 is that it vests DCMs with substantial authority to establish position limits or accountability rules outside of the spot-month for non-referenced contracts. However, the manner in which this discretion is expressed in proposed rule 150.5 can lead to confusion. For the sake of certainty, we urge the Commission to clarify that DCMs do have the discretionary authority to establish position limits or accountability rules, as necessary and appropriate, outside of the spot-month for non-referenced contracts.

D. The Commission must ensure position limits parity for the three wheat referenced contracts

Under the proposal, Kansas City ("KC") wheat would be subject to a limit of 6,500 contracts, which is considerably lower than current limits of 12,000 contracts. Current limits are based on the principle of parity between KC and Chicago Board of Trade ("CBOT") (and Minneapolis Grain Exchange, or "MGEX") wheat contracts, with the level based on applying the 10/2.5 percent formula to the open interest in the CBOT Soft Red Winter contract.[131] The Proposal breaks the principle of parity for establishing the same limit for the three wheat futures contracts, CBOT Soft Red Winter ("SRW"), KC Hard Red Winter ("HRW"), and MGEX Hard Red Spring ("HRS"). If implemented, this change would reduce the competitiveness of the KC and MGEX contracts at a time when these markets are poised for strong growth due to changes in Canadian government policy related to marketing of milling wheat and the transfer of the KCBT HRW contract to the CBOT designated contract market.

This would be in direct contravention of CEA section 4a(a)(2)(C)'s requirement that the Commission strive to ensure that price discovery in wheat does not migrate overseas. In contrast, a speculative position limits regime consistent with the principle of parity for wheat contracts would be more likely to ensure that price discovery in wheat doesn't migrate to Canadian or other exchanges. In addition, end users actively trade spreads between these three classes of wheat to help discover price differentials for their different protein levels and milling characteristics. The Proposal's unwarranted reversal of long-standing Commission policy would reduce the liquidity available for these spreading transactions, particularly given the Proposal's limited "intermarket spread" exemption. The Proposal's policy toward these wheat contracts would therefore run counter to the CEA section 4a(a)(3)(B) Safeguards that require the Commission to ensure sufficient market liquidity for bona fide hedgers and that the price discovery function of the underlying market is not disrupted.

[131] 76 Fed. Reg. at 4,760.

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IV. The Commission should categorically reject the Proposal's approach to bona fide hedging exemptions because it is contrary to statutory text and an unwarranted and costly departure from previous CFTC and exchange bona fide hedging standards

Under the current Commission-administered position limit framework for nine legacy agricultural futures contracts, a bona fide hedging position exemption is available when a trader (i) satisfies the general hedge definition in current rule 1.3(z)(1) and (ii) meets one of the enumerated hedge exemptions in current rule 1.3(z)(2) or (iii) does not meet one of the enumerated exemptions but follows the application process specifically provided in current rules 1.3(z)(3) and 1.47 to obtain a non-enumerated hedge exemption. The process for a non-enumerated exemption allows for a streamlined, time-delimited (30-day or less) review of an applicant's risk reducing hedge activities. Furthermore, with respect to exchange-set limits and exemptions, current rule 150.5(d) mandates that exchanges provide for bona-fide exemptions "in accordance with § 1.3(z)(1) [the general hedge definition] of this chapter."[132]

The Proposal expands federal limits to 19 newly referenced commodity markets and 471 contracts beyond those linked to the nine legacy agricultural futures contracts directly regulated by the Commission. These contracts are based on additional agricultural, crude and processed oils, natural gas, and metals commodities, and affect a much broader array of commercial traders, many of whom have committed to substantial capital investments and, as a result, have risks that may be hedged by positions in the Proposal's referenced contracts. Yet, despite the significantly expanded scope of the Proposal's federal limits, the rulemaking's framework actually narrows and constricts the availability of bona fide hedge exemptions that are routinely used today by market participants to reduce and control commercial risks.

There are no reasonable grounds in the Act, as amended by the Dodd-Frank Act, its legislative history, or in prior Commission precedent, to support this overly restrictive approach to bona fide hedging exemptions. Indeed, the Proposal's restrictive approach departs from the statute and longstanding Commission administrative precedent and lacks an adequate, reasoned justification for restricting the legitimate use of bona fide hedging exemptions. As a result, the Proposal's description of the types of hedging activities that would be recognized as bona fide, particularly with respect to traders that would be newly affected by expanded federal position limits, is grossly inadequate.

We respectfully request that the Commission reject the Proposal's overall posture, and recognize that any attempt to significantly expand the reach of federal limits must recognize risk reducing trading practices developed over the past 40 years to mitigate the commercial risks attendant to transacting in modernized and globally-integrated commodities markets. Any attempt to expand the reach of federal limits will negatively impact thousands of commercial firms and the operation of our derivatives markets. Such actions must be taken thoughtfully and in close collaboration with the exchanges and commercial market participants. Accordingly, we respectfully request that the Commission:

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[132] 17 C.F.R. § 150.5(d) (emphasis added).

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(1) Reject the Proposal's limiting of bona fide hedges to enumerated trading activities ("enumerated hedge regulations")[133] and publicly clarify that hedge positions are bona fide when they satisfy the hedge definition codified by Congress in section 4a(c)(2) of the Act, as added by the Dodd-Frank Act; or

(2) At a minimum, (i) reinstate a streamlined, time-delimited rule 1.47 process to allow parties to seek non-enumerated bona fide hedging exemptions and (ii) significantly expand the list of enumerated hedges to adequately allow commercial traders to engage in accepted risk reducing practices in commodity markets newly covered by federal position limits;

(3) Clarify that the enumerated hedge regulations in any case do not apply to exchange-set limits on non-referenced contracts;

(4) Clarify its guidance in the preamble concerning the "economically appropriate" bona fide hedging transaction or position criterion; and

(5) Reconsider its interpretation of the "substantial relation test."

A. The Commission should not accept the Proposal's enumerated hedge regulations as an appropriate approach to administering exemptions

1. <u>Excluding non-enumerated bona fide hedges without a functioning safety valve qualification exceeds the Commission's statutory authority</u>

Section 4a(c)(2) of the Act, as amended by the Dodd-Frank Act, applies three critical statutory criteria to define a "bona fide hedging transaction or position."[134] Section 4a(c)(2) of the Act also directs the Commission to define ("the Commission shall define") a "bona fide hedging transaction or position" as a position or transaction that satisfies these three criteria. In other words, while the Commission can exercise administrative discretion in applying the three statutory criteria to positions or transactions, it has no discretionary authority under section 4a(c)(2) of the Act to define bona fide hedges in a way that excludes commercial trading practices that satisfy the requirements of each criterion.

[133] Proposed rule 150.1, definition of "bona fide hedging position" at paragraph (2)(i)(D)(3).

[134] The language introducing CEA section 4a(c)(2)'s bona fide hedging position definition provides "[f]or the purposes of implementation of [position limits on futures positions], the Commission shall define what constitutes a bona fide hedging transaction or position as a transaction or position that" meets the three statutory criteria: (1) the "Temporary Substitute" criterion: that the bona fide hedging position "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"; (2) the "Economically Appropriate" criterion: that the bona fide hedging position "is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise"; and (3) the "Change in Value" criterion: that the bona fide hedging position "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 (III) services that a person provides, purchases, or anticipates providing or purchasing."

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Despite the statute's plain text, the Proposal's regulatory definition of a "bona fide hedging position or transaction," as would be codified in proposed rule 150.1, adds two criteria for a bona fide hedge that are not prescribed by CEA section 4a(c)(2) and are therefore entirely discretionary.

First, the Proposal adds an "incidental test" criterion that is included in current rule 1.3(z)(1) but excluded from section 4a(c)(2) of the Act. The Proposal's intent is for the "incidental test to be a requirement that the risks offset by a commodity derivative contract hedging position must arise from commercial cash market activities."[135] The Proposal justifies this added requirement because otherwise "it would be difficult to distinguish between hedging and speculative activities."[136] The Proposal also concludes that this requirement "is also embodied in the economically appropriate test."[137] It is unclear therefore what, if any, added policy benefit there is in introducing this requirement if it is already "embodied" in the statutory definition of a bona fide hedging transaction or position. If the "incidental test" adds or may be used to add any additional requirements beyond those in section 4a(c)(2), the Commission cannot accept the Proposal's criterion because it exceeds the Commission's statutory authority to define a "bona fide hedging transaction or position" in a manner inconsistent with the plain text of the Act.

Second, and most importantly, the Proposal would not only limit "bona fide hedging positions" to those that satisfy the three statutory criteria, but would also be extended to those that are specifically enumerated in the Proposal's regulations.[138] Because the Proposal's list of "enumerated" bona fide hedging positions do not recognize all positions or transactions that conform to the statutory bona fide hedging criteria in section 4a(c)(2), this additional layer of limitation exceeds the Commission's statutory authority and unnecessarily (and without adequate explanation) disallows recognizing legitimate risk reducing activities that commercial firms typically employ as bona fide hedges. In order to demonstrate the impact of this disallowance, we discuss below, a number of "non-enumerated" positions and transactions that meet the statutory criteria but nonetheless are not recognized as bona fide hedges by the Proposal's enumerated hedge regulations.

We note further that promoting "sound risk management" is a core policy goal under the Act.[139] While the Commission's current bona fide hedging exemption[140] and the statutory definition of "bona fide hedging transaction or position" accommodate "sound risk management," the Proposal's artificially restrictive definition of "bona fide hedging position" imposes costs in the form of constraints on risk management activities that would effectively reclassify large formerly exempt risk reducing positions above proposed limits as excessive speculation. These costs, in turn, would be borne by the ultimate

[135] 78 Fed. Reg. at 75,707.

[136] *Id.*

[137] *Id.*

[138] *Id.* at 75,823 rule 150.1 (definition of "Bona fide hedging position").

[139] CEA section 15(a)(2)(D), 7 U.S.C. § 19(a)(2)(D).

[140] 17 C.F.R. 1.3(z).

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end-users: the American consumer. The Proposal imposes these costs without adequate justification for their necessity, and without appropriately considering if the restrictive approach will curb excessive speculation. Not unexpectedly, the Commission's acceptance of the Proposal's approach would only constrain legitimate commercial risk reduction practices and introduce systemic risks that currently are lessened through employing these practices. We do not believe this negative impact was the intent of Congress, the Commission, or any Commissioner.[141]

2. Nothing in the legislative history of the Dodd-Frank Act supports applying the Proposal's enumerated hedge regulations to commercial hedgers managing physical commodity price risks

There is nothing in the legislative history of the Dodd-Frank Act that indicates Congress' desire to limit the ability of commercial market participants to claim bona fide hedge exemptions for actual or anticipated physical commodity price risks. To the contrary, there are many statements from members of Congress indicating that preserving the ability of commercial traders to manage their risks was a central goal of financial reform. Indeed, the Dodd-Frank Act language specifically defining a "bona fide hedging transaction or position" in section 4a(c)(2) of the Act was not included in the House Finance Committee, Senate or Treasury versions of the Dodd-Frank Act. Section 4a(c)(2) of the Act came from the bipartisan Peterson-Frank amendment originating in the House Agriculture Committee. The House inserted this provision into Dodd-Frank Act section 737 to address concerns that the provisions of the Dodd-Frank Act or the regulators implementing it *might hinder the ability of commercial market participants to hedge physical commodity price risk*.[142] Members of the Senate made similar comments regarding the importance of enabling bona fide hedgers to continue to utilize derivatives markets by cautioning the Commission to "not make hedging so costly it becomes prohibitively expensive for end users to manage risk."[143] Therefore, the Commission should not interpret statutory language meant to

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[141] Commissioner Chilton articulated the Commission's actual intent regarding bona fide hedge exemptions, stating that they should "encourage and not unduly complicate prudent commercial risk management practices." Statement of Commissioner Chilton, The End-User Bill of Rights, Apr. 3, 2013, available at http://www.cftc.gov/PressRoom/SpeechesTestimony/chiltonstatement040313.

[142] *See, e.g.,* Peterson-Frank Amendment, H.R. 4173, Dec. 10, 2009, at section 3113, *available at* http://thomas.loc.gov/cgi-bin/query/C?r111:./temp/~r111e4mwIC; *House Passes Peterson-Frank Amendment to Strengthen Regulation of Over-the-Counter Derivatives*, U.S. House of Representatives Committee on Agriculture Press Release (Dec. 10, 2009), *available at* http://democrats.agriculture.house.gov/press/PRArticle.aspx?NewsID=207 (announcing that the amendments "preserv[e] the use of derivatives for end users to hedge price risks associated with their businesses"); Floor Statement by the Honorable Frank D. Lucas, Ranking Member, House Committee on Agriculture, Re: H.R. 4173, the Wall Street Reform and Consumer Protection Act (Dec. 10, 2009), *available at* http://republicans.agriculture.house.gov/fs091210.shtml ("we were able to improve areas most important to end-users – the manufacturers, the energy companies and food processors that use swap agreements to manage price risk so they can provide consumers the lowest cost products").

[143] Letter from Sen. Christopher Dodd and Sen. Blanche Lincoln to Rep. Barney Frank and Rep. Colin Peterson (June 30, 2010).

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preserve a hedger's pre-Dodd Frank risk management tools as authorizing, let alone mandating, additional restrictive requirements not otherwise supported under the CEA.

3. <u>The Proposal's enumerated hedging regulations conflict with longstanding Commission practice and precedent, and their adoption would be arbitrary and capricious</u>

Eliminating the availability of exemptions for a "non-enumerated" bona fide hedging position is a departure from past (non-vacated) Commission rules. The statutory definition of a "bona fide hedge" in section 4a(c)(2) of the Act is, with a one word exception, the same as the Commission's historic "general definition of bona fide hedging,"[144] and has been used by the Commission and contract markets since 1977.[145]

In the proposing release to the Commission's 1977 amendments of the bona fide hedging definition, the Commission described the difference between enumerated and non-enumerated bona fide hedging positions. First, enumerated bona fide hedging positions (proposed to be codified at 17 C.F.R. 1.3(z)(2)) were those transactions that conformed to the "general definition" of bona fide hedging (proposed to be codified at 17 C.F.R. 1.3(z)(1)) "without further consideration as to the particulars of the case."[146] This general definition was ultimately adopted as Commission regulation 1.3(z)(1) and is almost identical to what Congress has now codified in section 4a(c)(2) of the Act.

Second, the non-enumerated bona fide hedging positions (proposed to be codified at 17 C.F.R. 1.3(z)(3)) were positions that still qualified for the bona fide hedging exemption but required "evidence that such transactions meet the requirements of" the general definition of a bona fide hedging position.[147] The Commission explained that the exemption for "non-enumerated" bona fide hedging was "to provide flexibility in [the] application of the general definition and to avoid an extensive specialized listing of enumerated bona fide hedging transactions."[148] The Commission confirmed this

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[144] 17 C.F.R. 1.3(z)(1).

[145] Definition of Bona Fide Hedging and Related Reporting Requirements, 78 Fed. Reg. 42,748 (Aug. 24, 1977) (promulgating 17 C.F.R. 1.3(z)). The one word difference is the Temporary Substitute criterion (the stricken word indicating a term dropped in the CEA section 4a(c)(2): the bona fide hedging position "~~normally~~ 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."

[146] Bona Fide Hedging Transactions or Positions, Proposed Rulemaking and Request for Comment, 42 Fed. Reg. 14,832 (Mar. 16, 1977) [hereinafter the *1977 NOPR*].

[147] *Id.* at 14,833.

[148] *Id.*

purpose of the non-enumerated hedge exemption in its final rulemaking adopting the 1977 bona fide hedging rules ("1977 Final Rules").[149]

Furthermore, the 1977 Final Rules emphasized the purpose of the Commission's bona fide hedging exemption: "to increase commercial utilization of futures markets for the purpose of hedging by allowing additional exemptions [from speculative position limits]."[150] In addition, the Commission aimed to "increase commercial participation through recognition of a broad range of current risk shifting uses of futures markets."[151] In the 1977 Final Rules, the Commission also addressed several commenters who asserted that the enumerated transactions in 1.3(z)(2) would be "deficient for certain commodities where the Commission currently has no speculative limits."[152] The Commission responded that it was aware of this possibility, but, as it noted in the 1977 NOPR, it "does not believe that it is necessary to enumerate transactions and positions which would be considered bona fide hedging in markets where it currently has no speculative limits."[153] The necessary corollary of this statement is that if the Commission expanded its list of commodities for which it imposes limits, it would also need to expand the list of enumerated transactions or, given its desire to "avoid an extensive specialized listing of enumerated bona fide hedging transactions," extend the review of non-enumerated positions and transactions "to provide flexibility in [the] application of the general definition."[154]

Importantly, as these seminal rulemakings make clear, from the time the Commission first adopted enumerated hedge exemptions in 1977, at no time—until 2011—had the Commission either (i) limited bona fide hedging position exemptions to enumerated hedges without recourse to a time-delimited and streamlined process to obtain a non-enumerated hedge exemption or (ii) suggested that it is appropriate to narrow the list of enumerated hedges despite evidence that the listed enumerated hedges are "insufficient" to capture all otherwise bona fide hedging strategies that are used by commercial firms transacting in the contracts subject to position limits. To the contrary, Commission precedent suggests that the use of enumerated hedges was a permissive device to allow the Commission to grant bona fide hedging position hedge requests "without further consideration as to the particulars of the case."[155]

Instead of providing a list of enumerated hedges to serve as a collection of readily recognized bona fide hedging positions that need no "further consideration," and instead of concurrently adopting

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[149] Definition of Bona Fide Hedging and Related Reporting Requirements, Proposed Rulemaking and Request for Comment, 42 Fed. Reg. 42,748 (Aug. 24, 1977).

[150] *Id.* at 42,748.

[151] *Id.*

[152] *Id.* at 42,750.

[153] *1977 Final Rules,* 42 Fed. Reg. at 42,750.

[154] *Id.* at 14,833.

[155] *1977 NOPR* at 14,832.

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a process for parties to efficiently request non-enumerated transactions, the Proposal reverses the Commission's longstanding policy without any reasoned explanation and without so much as an acknowledgement that it is departing from prior Commission policy. Changing, but failing to explain the change and address prior historic policy, has been considered by the Supreme Court as constituting an arbitrary and capricious action under the Administrative Procedure Act.[156] Accordingly, the Commission should, at a minimum, (i) reinstate the streamlined, time-delimited rule 1.47 process to allow parties to seek non-enumerated bona fide hedging position exemptions and (ii) expand the list of enumerated hedges to adequately allow commercial participants to engage in all hedging activities which are permissible under the general hedge definition now codified in section 4a(c)(2) of the Act.

4. <u>The Proposal's approach to non-enumerated bona fide hedging regulations does not further any legitimate policy objectives</u>

Under section 4a(c)(1) of the Act, the Commission is directed to define bona fide hedging terms "consistent with the purpose of this Act." Although required to adopt the statutory bona fide hedging definition for purposes of position limits adopted under section 4a(a)(2) of the Act, the statute otherwise allows the Commission wide discretion to define bona fide hedging positions "to permit producers, purchasers, sellers, middlemen, and users of a commodity or a product derived therefrom to hedge their legitimate anticipated business needs for that period of time into the future for which an appropriate futures contract is open and available on an exchange."[157] With respect to position limits established under section 4a(a)(2) of the Act, when actually setting limit levels or shaping other elements of a limits framework, the statute provides that the Commission "shall set limits. . . to the maximum extent practicable, in its discretion" to also "ensure sufficient market liquidity for bona fide hedgers."[158] Therefore, consistent with the discussion in the above sections, the Congressional intent embodied in this statutorily-delineated goal is to enable the commercial risk reducing trading practices of bona fide hedgers on an ongoing basis.

Eliminating the non-enumerated exemptions does nothing to further the statutory goals of allowing commercial parties to "hedge their legitimate anticipated business needs."[159] To the contrary,

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[156] *See Motor Vehicle Mfrs. Assn. of United States, Inc. v. State Farm Mut. Automobile Ins. Co*., 463 U.S. 29, 57 (1983) (an agency changing its policy must articulate a reasoned analysis for its change). *See also FCC v. Fox Television Stations, Inc*., 556 U.S. 502, 529 (2009) ("To be sure, the requirement that an agency provide reasoned explanation for its action would ordinarily demand that it display awareness that it is changing position. An agency may not, for example, depart from a prior policy sub silentio or simply disregard rules that are still on the books.") (citing *United States v. Nixon*, 418 U.S. 683, 696 (1974)). While an agency does not need to show that the stated reasons for the new policy are better than the reasons for the old policy, it does need to show "that there are good reasons for it, and that the agency believes it to be better, which the conscious change of course adequately indicates." *Id.* (emphasis added).

[157] Commodity Exchange Act § 4a(c)(1).

[158] *Id.* § 4a(a)(3).

[159] *Id.* at § 4a(c)(1).

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the Proposal's overly restrictive and prescriptive approach would force businesses to forego hedging activities that become too difficult or costly to adopt if such activities risk approaching, let alone violating, position limits. The Proposal in part justifies eliminating the exemption for non-enumerated bona fide hedge positions because "almost all [non-enumerated bona fide hedging exemptions] were for risk management of swap positions related to the agricultural commodities subject to federal position limits."[160] This argument is not relevant to energy or metals or non-legacy agricultural markets, however.

As noted by the Commission when it created the list of enumerated bona fide hedging positions in 1977, transactions and positions enumerated as bona fide hedging "would be deficient for certain commodities where the Commission currently has no speculative limits."[161] At that time, and as of today, the Commission has only administered speculative position limits for certain agricultural commodities. The Commission has not experienced the widespread use of the non-enumerated provisions of the bona fide hedging exemption because it has not administered speculative position limits for the other 19 referenced commodity markets and the 471 referenced contracts linked to these markets. The Proposal's failure to establish an appropriate process for recognizing non-enumerated hedges therefore critically undervalues its importance to commercial market participants.

We also note that the Proposal has failed to consider the factors in section 4a(a)(3)(B) of the Act in exercising discretion to narrow the statutory definition of a bona fide hedge strictly to enumerated positions and transactions. If it resolves to eliminate the exemption for non-enumerated bona fide hedging positions, the Proposal will:

- Encourage the migration of price discovery and liquidity away from U.S. markets to overseas markets, particularly for multinational firms that manage price risk related to an international commodity (e.g., crude oil, sugar, coffee, cocoa, and other world commodities). For these multinational firms, the artificial restrictions the Proposal is introducing into U.S. markets will lead many to seek hedging opportunities in competitor contracts abroad that are either not subject to speculative position limits or apply a less restrictive approach to a hedge exemption from position limits. CME Group knows of specific market participants who have, in fact, made this point clear. We believe that market participants have also engaged the Commission to express the same message directly.

- Undermine the price discovery function of the underlying physical-delivery futures contract. This is because many enumerated bona fide hedging positions (e.g., anticipated production and cross-commodity hedges) in excess of spot month limits are generally disallowed in physical-delivery benchmark futures contracts during the spot month.

- Directly undermine liquidity for bona fide hedgers by limiting the instances where their swap counterparties can hedge the price risk associated with a non-enumerated bona fide hedging swap (for example, a swap hedging certain anticipated price risks, as described below or an

[160] *See* I, 78 Fed. Reg. at 75,710 (to be codified at 17 C.F.R. 150.2(e)(4)).

[161] *1977 Final Rules*, 42 Fed. Reg. at 42,750.

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enumerated bona fide hedging swap subject to the "five-day rule" (for example, a swap that would optimally provide delivery term optionality, through offsetting risk in physically delivered crude oil futures, for a refiner's anticipated requirements - under this scenario, there is no basis for precluding a swap dealer from establishing spot month positions in physically delivered crude oil futures to obtain physical optionality for a bona fide hedging counterparty).[162]

- Indirectly undermine liquidity for bona fide hedgers by discouraging the participation of other bona fide hedgers, particularly in physical-delivery benchmark futures contracts.

- Not in any way reduce the probability of "excessive speculation" or manipulation exemplified by Amaranth or the Hunt Brothers. Neither Amaranth nor the Hunt Brothers used or abused a non-enumerated bona fide hedging exemption. "Amaranth was a pure speculator that, for example, could neither make nor take delivery of physical natural gas."[163] "The Hunt brothers were speculators who neither produced, distributed, processed nor consumed silver."[164]

5. <u>The Proposal's alternative to its enumerated bona fide hedging regulations is grossly inadequate</u>

Commercial market participants utilize risk reduction practices in order to manage uncertainty and mitigate unwanted risk. Under previous Commission regulations and exchange rules, commercial market participants were able to hedge their risks without concerns for regulatory risk so long as their hedge positions conformed to the general definition of bona fide hedging in Commission rule 1.3(z)(1) and the appropriate procedures were followed. Under Commission rule 1.47, for a non-enumerated bona fide hedging position in a legacy agricultural contract, the Commission had 30 days to approve or deny an "initial statement" for a non-enumerated bona fide hedging exemption and 10 days to approve or deny a "supplemental report." The standards by which the Commission would deny such claims for an exemption were transparent: these claims had to comport with the general definition of bona fide hedging under Commission rule 1.3(z)(1).

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[162] In addition, if an available cash-settled market is illiquid, the five-day rule would compel a swap dealer near a limit to not provide liquidity to bona fide hedgers, or alternative, to provide such liquidity and offset the acquired price risk in illiquid cash-settled contracts. Offsetting risk in illiquid futures would force the dealer to pay a liquidity premium that would, at least to some extent, be passed on to hedgers. Overall, the Proposal's restrictions would saddle bona fide hedgers with less liquidity and increased cost. The ability to provide physical optionality through access to physical delivery futures, on the other hand, would promote liquidity and reduce a swap dealer's transactional costs by mitigating both volumetric and price risks. Volumetric risk would be mitigated through a benchmark futures contract's physical delivery mechanism. Price risk would be mitigated by access to more liquid bench market futures.

[163] *See Proposed Rules* at 75,692 n. 103 ("Amaranth was a pure speculator that, for example, could neither make nor take delivery of physical natural gas.").

[164] *Id.* at 75,686.

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The Commission's proposed approach to non-enumerated bona fide hedging positions introduces unprecedented regulatory uncertainty to commercial market participants' risk management programs. In lieu of a reasonable, "innocent until proven guilty" approach, the Proposal furthers a "guilty until proven innocent [maybe]" approach.[165] Under proposed rule 150.3, a person engaging in risk-reducing practices "commonly used in the market, which they believe may not be specifically enumerated in the definition of a bona fide hedging position in § 150.1" must now either (i) seek an interpretative letter from staff under Commission rule 140.99; or (2) file for formal Commission-level exemptive relief under section 4a(a)(7) of the Act. The standards under which staff or the Commission may grant this relief are opaque, and given the Proposal's unusual skepticism regarding many standard commercial risk management practices, unlikely to be granted. Indeed, the Proposal appears to grossly misunderstand the radical changes it has introduced, as demonstrated by its belief that:

> The proposed amendments to § 150.3(e) and the replacement of existing § 1.47 with new proposed § 150.3(f) are essentially clarifying and organizational in nature. As such they will confer limited substantive benefits beyond providing market participants with clarity regarding the process for obtaining non-enumerated exemptive relief and promoting regulatory certainty for those granted exemptions pursuant to § 1.47.[166]

While CME Group of course agrees that not all risk reducing practices can be described by enumerated hedging exemptions, the above processes are wholly inadequate for at least three reasons. First, as we have noted above, the Proposal's attempt at providing what can at best be described as limited relief departs from past precedent without a reasoned explanation. Second, neither alternative is time-delimited, and thus commercial end-users seeking clarity would have no way to know if they would obtain a hedge exemption in time to make their intended hedge positions legal. Exemptive relief under section 4a(a)(7) of the Act, in particular, is likely to entail a lengthy process and appears to subject the applicant to the notice and comment administrative process which is not conducive to quickly validating the trading activity of commercial market participants.[167] Furthermore, based on our experience with requesting no-action and interpretive relief throughout the Commission's Dodd Frank Act implementation process, it has become clear that staff does not interpret rule 140.99 as mandating an official response to any request, which can only lead to greater regulatory uncertainty for hedgers attempting to pursue this option. Third, given the Proposal's enumerated hedge regulations, it is unclear whether a staff interpretive letter under Commission rule 140.99 would allow commercial hedgers to seek approval of a risk reducing position that does not fit within the four corners of an enumerated hedge (but which would readily satisfy the three statutory criteria of a bona fide hedge) or whether a staff interpretation is limited to confirming whether uncertain hedge positions in fact fit within one of the enumerated hedges. If the latter, the relief is far too limited. If the former, CME

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[165] Commissioner Scott D. O'Malia, Statement of Dissent, Position Limits for Futures and Swaps, *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/omaliastatesment101811d (Oct. 18, 2011).

[166] *See Proposed Rules* at 75,772.

[167] CME Group notes that the Working Group of Commercial Energy Firms filed a petition under section 4a(a)(7) of the CEA on January 20, 2012 that remained unanswered as of September 28, 2012, when the prior position limit rules were vacated by court order.

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Group is concerned that staff will not have sufficient authority or willingness to provide prompt and meaningful interpretations that a given, non-enumerated strategy qualifies as a bona fide hedging position.

The prior Commission process was workable, and no reasoned explanation is given by the Proposal for its elimination. Accordingly, we urge the Commission to not accept the Proposal's approach, and in any possible future action, endorse procedures similar to existing rule 1.47 to permit and fully authorize staff (or as discussed below, the exchanges) to review and grant exemptions for non-enumerated hedging positions within a time-specific period.

6. The Proposal's analysis and rejection of specific commercial risk reducing practices as non-bona fide is flawed

a) The "five-day rule," restricting the ability to exempt certain enumerated bona fide hedges in the shorter of the last five days of trading or the spot month, is flawed

The Proposal seeks to eliminate the ability of bona fide hedgers, even those with an otherwise recognized enumerated bona fide hedging position, to claim a hedge exemption in the shorter of the last five days of trading or the spot month for a physically delivered benchmark futures contract (the "five-day rule"). The five-day rule has its origin in the Commission's 1977 rulemaking. Even in 1977, however, the Commission allowed market participants to claim non-enumerated hedge exemptions for positions that were not specifically excluded under the five-day rule.[168]

(1) There is no reason to apply the "five-day rule" to disallow short anticipatory positions based on anticipated production that can be delivered

Under the five-day rule, the Proposal recognizes hedges of inventory but does not recognize hedges of unsold anticipated production, despite the fact that both hedges are enumerated. When a commodity producer is "highly" or "reasonably" certain that it will produce a commodity deliverable in the appropriate benchmark futures delivery period, there is no adequate statutory or policy reason, or reason grounded in sound economic theory, not to treat that anticipated production as inventory. For example, while anticipated gas production may be located many hundreds or even thousands of miles from the Henry Hub delivery location, this natural gas production can be made deliverable through displacement in the national natural gas pipeline network.

There are compelling policy reasons for, and practical benefits that would flow from, allowing producers to claim an anticipated production bona fide hedge in the spot month of a physically delivered benchmark futures contract. For natural gas producers, preserving this exemption would preserve their ability to make delivery on production on the physical-delivery NYMEX Henry Hub contract when this contract price is trading at higher than the cash market price. Such transactions, as do other convergence trades, promote the price discovery function of physically delivered benchmark

[168] *1977 Final Rules*, 42 Fed. Reg. at 42,750, 42,751.

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futures contracts.[169] The Proposal provides no sound basis for its categorical application of the five-day rule when this restriction can unnecessarily hamper convergence, reduce liquidity for bona fide hedgers and detrimentally affect price discovery in physically delivered benchmark futures.

b) The Proposal's approach to certain anticipated merchandising hedges is flawed

The Commission's vacated rule 151.5(a)(2)(v) provided for an enumerated exemption for "anticipated merchandising hedges." The Proposal has discarded this exemption and now argues that when merchandising price risk is anticipated, a hedging transaction "could not reduce this yet-to-be assumed risk" and therefore, anticipated merchandising fails to meet the "Change in Value" criterion of the bona fide hedging definition.[170] The Commission cannot and should not accept the Proposal's categorical exclusion of anticipated merchandising from the definition of bona fide hedging.

As discussed above, the Proposal *cannot* invoke section 4a(c)(2) of the Act as authority for narrowing the definition of bona fide hedging to exclude anticipated merchandising. This would run afoul of the plain language of the Act. The "Change in Value" criterion embedded in section 4a(c)(2)(A)(iii) of the Act explicitly covers "potential change[s] in value of. . .assets that a person. . .anticipates owning. . .or merchandising." The Proposal therefore defiantly seeks to override Congressional intent by claiming that anticipated merchandising-related price risks do not conform to the "Change in Value" criterion when the plain text of the criterion explicitly identifies such price risks.

The Commission should also reject the Proposal's narrowing of the bona fide hedging definition to exclude anticipated merchandising for fundamental public policy reasons. Merchandising activities function as linkages that bind and define markets by moving commodities in cash marketing channels from where they are to where they are needed in response to pricing signals. Such activities, when facilitated by futures positions, inherently promote price convergence and the price discovery function of physically delivered benchmark futures contracts.[171] In this regard, the Proposal correctly describes the classic convergence trade by noting that:

> [T]he Commission has observed when a physical-delivery contract is trading at a price above prevailing cash market prices, commercials with inventory tend to sell contracts with the intent of making delivery, causing physical-delivery prices to converge to cash market prices. Similarly, the Commission has observed when a physical-delivery contract is trading at a price below prevailing cash market prices, commercials with a need for the commodity or merchants active in the cash market tend to buy the

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[169] Commodity Exchange Act § 4a(3)(B)(iv), 7 U.S.C. § 6a(3)(B)(iv) (in establishing a position limits regime the Commission is "to ensure that the price discovery function of the underlying market is not disrupted.").

[170] 78 Fed. Reg. at 75,718 quoting 76 Fed. Reg. at 71,646.

[171] *See* CEA section 4a(a)(3)(B)(iv), 7 U.S.C. § 6a(a)(3)(B)(iv).

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contract with the intent of taking delivery, causing physical-delivery prices to converge to cash market prices.[172]

By limiting merchandisers' abilities to hedge their anticipated commercial transactions that conform to current Commission rule 1.3(z) and the plain text of section 4a(c)(2) of the Act, the Proposal would artificially constrain large transactions that promote price discovery, particularly during the spot month, and then particularly in physically delivered benchmark futures contracts, without any commensurate benefit. In so doing, the Proposal would place artificial barriers to prudent risk management practices, and deter activity that contributes to liquidity and price discovery without reducing excessive speculation or the likelihood of manipulation.[173]

In its vacated prior rules, the Commission specifically included the anticipated merchandising hedge in the list of enumerated hedge transactions, and even included a "fact pattern" explaining why a grain merchandiser's hedge of a storage facility appropriately hedges the merchandiser's "risk that its unfilled storage capacity will not be utilized over th[e] period" of its hedge.[174] The Commission concluded that a hedge that is a substitute for a fixed-price forward purchase and a fixed price forward sale of an equivalent volume meets the general hedge definition of section 4a(c)(2) of the Act. The Commission, at that time, correctly identified the associated price risks and correctly found that a merchandiser's spread hedge met the general hedge definition. Now, however, the Proposal incoherently invalidates the Commission's prior conclusion and questions whether the spread hedge correlates to the expected returns ("rents") of a merchandiser's facility.

The Commission had it right the first time. The risk to the merchandiser is not merely the rents for the facility, but also the risk that the capital asset (the facility) will not be used, and hence revenues would not be generated to cover the fixed costs of the facility. If the merchandiser can hedge this risk, it would have an incentive to raise necessary capital, hedge its investments, and invest in needed infrastructure. Furthermore, storage rents can be, and commonly are, price-based on the market value of a spread. Therefore, facility owners and lessees should be permitted to lock in spreads today in order to eliminate the risk of the spread value decreasing tomorrow. In other words, merchandizers, as statutorily recognized commercial firms effectuating statutorily recognized commercial risk reducing trading practices, must be recognized as bona fide hedgers.

It would be contrary to the purposes of the Act and sound risk reducing practices to permit a storage owner or lessee to hedge only after inventory is committed to being purchased, but not in anticipation of acquiring and moving such inventory because such risk is "yet-to-be assumed" risk. In the absence of a hedge exemption for anticipated merchandising activity, a merchandiser would have to wait until it has cash purchase and sales commitments to lock in a profit. In contrast, with an

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[172] 78 Fed. Reg. at 75,737 n. 463.

[173] CEA section 4a(a)(3)(B), 7 U.S.C. § 6a(a)(3)(B).

[174] 76 Fed. Reg. at 71,698. The hedge included certain protections to address concerns about legitimate corporate risks, including a requirement to have an ownership or lease of storage capacity, a requirement to not exceed unsold storage, and data submissions showing, among other things, three years of storage data.

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anticipatory spread hedge position a merchandiser can lock in a profit before cash market purchases and sales are conducted, providing the merchandiser cash flow certainty.

With respect to matching purchases and sales on the different dates, the Proposal neglects to note that a storage hedge can be rolled forward as needed to line up supply and demand in the withdrawal period and still reduce the overall risk of losing substantial value in the spread. For these reasons, commercial market participants must to be allowed to engage in longstanding practices that mitigate anticipated merchandising risks under any appropriately structured position limits framework.

Similarly, and without a reasoned basis, the Proposal also does not recognize hedges of a floating-price risk between a concluded purchase or sale contract that is expected (or anticipated) to be offset with floating-price sale or purchase contract as eligible for a bona fide hedging exemption. The Proposal reasons that under this scenario the "Change-in-Value" criterion has not been met because "a trader has not established a definite exposure to a value change when that trader has established only an unfixed price purchase or sales contract."[175]

We strongly disagree. As discussed above, the statutory "Change in Value" criterion explicitly includes anticipated merchandising-related price risks. This would include the hedging of floating-price risk representing the difference between a concluded purchase or sale and the anticipated offset. The Proposal provides a policy rationale for its restrictive approach to anticipated merchandising by expressing the concern "that exempting such a yet-to-be established cash position would make it difficult or impossible for the Commission to distinguish hedging from speculation."[176] The Commission illustrates this concern with an example:

> [A] trader could maintain a derivatives position, exempt from position limits, until that trader enters into a subsequent cash market transaction that results in a book-out of the first unfixed-price cash market transaction. The trader could assert that changed conditions resulted in a change in intentions. Since market prices are continually changing to reflect new information and, thus, changing conditions, the Commission believes an exemption standard based on merchandizing intentions alone would be no standard at all.[177]

The statutory definition of a bona fide hedging transaction or position is equipped to deal with this type of abuse irrespective of the Proposal's assertions. Once the anticipated merchandising price risk is no longer anticipated, that is, when there is a "subsequent cash market transaction that results in a book-out" then the hedge position no longer qualifies as a bona fide hedging position because it is no longer reducing price risk. Moreover, the possibility of improper use exists for almost any anticipated price risk hedging exemption. Anticipated merchandising is no different than any other anticipated commercial activity in that merchandisers intend to make a profit based on anticipated activities in the physical marketing channel. There is no statutory or policy reason to treat future merchandising any

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[175] 78 Fed. Reg. at 75,719.

[176] 78 Fed. Reg. at 75,719.

[177] *Id.*

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differently than future production or processing or any other commercial activity. Disallowing the recognition of legitimate trading practices as bona fide hedges, particularly when such practices readily satisfy the statutory requirements of CEA section 4a and promote its public interest purposes, is not an appropriate response to unsupported notions of potential abuse. Concerns about potential abuse can be dealt with through effective oversight.

7. Concerns about limited resources to review non-enumerated bona fide hedging filings can be mitigated by leveraging exchange resources

The CME Group understands that the Commission may have limited resources to review all non-enumerated hedge requests. The CME Group submits first that the potential for insufficient resources is not an appropriate reason for limiting access to bona fide hedge exemptions, but an obvious indication that the Proposal's scope has extended far beyond where it rightly should stop. As with other predicaments in which the Proposal places the Commission and its staff, this resource-based predicament is yet another Proposal-manufactured problem.

In any event, DCMs have a long history of reviewing hedging approaches and applying those approaches to facts and circumstances. This history should not be ignored. The Proposal recognizes this in the context of excluded commodity hedges, as it provides that a hedge may qualify as a bona fide hedging position if it "[i]s enumerated in paragraph (3), (4) or (5) of this definition" or if "[s]uch position is recognized as a bona fide hedging position by the designated contract market or swap execution facility that is a trading facility, pursuant to such market's rules submitted to the Commission, which rules may include risk management exemptions consistent with Appendix A of this part."[178] The Commission would best serve the policy goals of protecting bona fide hedging position applicants by adopting the similar language for hedges of physical commodities.

B. The Commission should clarify that the Proposal's enumerated hedge regulations would not, in any case, apply to exchange-set limits on non-referenced contracts

The Commission should clarify that DCMs and SEFs are not required to adopt a definition of bona fide hedging position that is limited by to the Proposal's enumerated hedge regulations, at least as applied with respect to contracts that are not defined as referenced contracts. Proposed rule 150.5(2)(i) states that "[a]ny hedge exemption rules adopted by a designated contract markets or a swap execution facility that is a trading facility must conform to the definition of bona fide hedging position in § 150.1." However, unless the Commission changes the 150.1 definition to eliminate the requirement that a bona fide hedging position must satisfy one of the enumerated hedges (as we suggest it does), proposed rule 150.5(2)(i), read together with proposed rule 150.1, would apparently require DCMs and SEFs to define bona fide hedging positions to include the requirement that such positions satisfy one of the enumerated hedges in paragraph (3), (4) or (5) of the Proposal's regulatory bona fide hedging definition—*even as to non-referenced contracts that the Commission has not examined or considered in this rulemaking*. The Commission should not allow the Proposal to impose this result. The Commission should further affirm that any regulatory definition of bona fide hedging adopted under section 4a(c)(2)

[178] Proposed section 150.1 (definition of "bona fide hedging position").

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of the Act applies only to limits set by the Commission pursuant to section 4a(a)(2) of the Act, and not to exchange-set limits.[179]

The Commission has never before required DCMs to adopt bona fide hedging rules that limit hedges only to enumerated transactions—in fact the existing rules, which require exchanges to conform their bona fide hedging position definitions to Commission rule 1.3(z)(1) (the general definition) and not 1.3(z)(2) (the enumerated hedges), *conspicuously* avoids such a limitation.[180] This distinction was made for a good reason. As explained above, in adopting the 1977 enumerated hedges, the Commission was cognizant of the fact that the list of enumerated hedges in rule 1.3(z)(2) would be "deficient for certain commodities where the Commission currently has no speculative limits."[181] For this reason, the Commission responded to the commenters that it was aware of this possibility, but explained that it "does not believe that it is necessary to enumerate transactions and positions which would be considered bona fide hedging in markets where it currently has no speculative limits."[182]

If the Commission accepts the Proposal's attempt to require exchanges to define bona fide hedging positions the same way as in proposed rule 150.1 (with mandatory enumerated hedge regulations), it must understand that it would indirectly, but substantially, expand the commodities and contracts that would be subject to the Proposal's restrictive enumerated hedge regulations. Based on the statute and precedent discussed above, the Commission cannot fairly expand the list of commodities and products that would be subject to the Proposal's enumerated hedge regulations without ensuring that an enumerated hedge, or a flexible process for recognizing un-enumerated hedges, is available for all commercial risk reduction trading practices that use non-referenced contracts and satisfy the general hedge definition.

It would be arbitrary and capricious to force exchanges indirectly to, as the Proposal seemingly aspires to accomplish, limit all DCM and SEF bona fide hedging exemptions to the list of enumerated hedges in proposed rule 150.1 without even attempting to examine whether that list of enumerated hedges is or is not "deficient" for the contracts in question. We point to the non-enumerated hedges discussed in this letter as specific examples of legitimate commercial risk reducing positions that would be excluded from the bona fide hedging exemption under the Proposal and, as currently contemplated, also from any bona fide hedging definition applied to DCM-administered speculative position limits.

It is arbitrary and capricious to impose such an impactful and novel restriction on DCM and SEF definitions of bona fide hedging positions without an adequate and reasoned explanation of the appropriateness of the departure from the Commission's long-standing practice of vesting registered entities with the discretion to administer such definitions. For the above reasons, we therefore

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[179] "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…" CEA section 4a(c)(2), 7 U.S.C. § 6a(c)(2).

[180] 17 C.F.R. 150.5(d).

[181] 1977 Final Rules, 42 Fed. Reg. at 42,750.

[182] *Id.*

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recommend that the Commission reject the Proposal's attempt to restrict the bona fide hedging exemptions recognized by registered entities to the Proposal's enumerated hedges, at least as applied to contracts subject to exchange-set position limits.

C. The Proposal's interpretation of the "economically appropriate" bona fide hedging criterion should not be accepted

The Commission should clarify its guidance on the "economically appropriate" criterion of the bona fide hedging position exemption to acknowledge the complexities associated with managing a modern commercial enterprise. The Proposal suggests that in order for a "position to be economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, the enterprise generally should take into account all inventory or products that the enterprise owns or controls, or has contracted for purchase or sale at a fixed price."[183]

The Commission should be cognizant that, despite the Proposal's conception of hedging practices, the risks most commercial enterprises face are seldom internally netted on a one-to-one basis. A commercial enterprise may have price risk arising from activities relating to a variety of different commodities, different grades of commodities, different locations, different processing and production facilities, and different access to transportation infrastructures. All of these factors come together in determining the price risks that exist and the price risks that should be considered as reduced. For example, it may not be economically appropriate to net the price risk of a fixed-price month-ahead purchase of one grade of commodity in one location against a fixed-price month-ahead sale of another grade at another location.

Depending on the circumstances, it may be economically appropriate to transform one form of price risk into another form of price risk that is more easily managed, such as converting fixed-price risk to floating-price risk or vice-versa, or converting un-priced risk to floating average price risk. Under certain circumstances, a hedge transaction may shift risk (without increasing overall risk) from one business line to another business line. For example, an integrated oil company may determine to undertake a "pure play" strategy (i.e., not hedging any price risk associated with its production and marketing of that production) in its upstream operations (i.e., production) while deciding to protect margins through a comprehensive risk management program for its downstream operations (e.g., refining). Such an integrated commercial enterprise must be allowed to freely hedge its downstream operations, particularly when such operations would readily support a hedge exemption were they not conducted by related companies.

Moreover, footnote 450 of the Proposal suggests that "whether it is economically appropriate for one entity to offset the cash market risk of an affiliate depends, in part, upon that entity's ownership interest in the affiliate."[184] CME Group unequivocally disagrees that corporate ownership percentages should dictate whether a hedge is "economically appropriate." Many commercial firms participate in joint ventures where a majority or even minority equity interest owner may be responsible for

[183] 78 Fed. Reg. at 75,709.

[184] 78 Fed. Reg. at 75,736 n. 450.

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marketing the commodity produced by the venture and for managing the venture's price risks.[185] In such circumstances, it may be economically appropriate for the joint venture's physical commodity price risk to be managed in whole (not by pro rata equity share) by the enterprise whose affiliate is responsible for marketing production. In short, the integrated nature of commercial operations, or corporate ownership interests cannot be used as blunt determinants dictating the economic appropriateness of commercial risk reducing practices.

Finally, we note that the Commission has never accepted the Proposal's restrictive reading of the Commission's "economically appropriate" criterion. The architects of the bona fide hedging definition codified in Commission rule 1.3(z)(1), and now adopted by Congress in section 4a(c)(2) of the Act, described the meaning of the "economically appropriate" test, while discussing Commission rule 36.3(c) (1984), as follows:

> This concept []has been conveyed by the terms "for other than speculative purposes by producers, processors, merchants or commercial users engaged in handling or utilizing the commodity…"[186]

We urge the Commission to not depart from its precedent as recommended by the Proposal, and therefore continue to interpret the "economically appropriate" criterion non-prescriptively and in a manner that does not unduly restrict a commercial firm's ability and freedom to determine a risk management strategy appropriate to its business. If the Commission is concerned with specific commercial risk management practices, it should identify these types of activities, analyze them under section 4a of the Act and the public interests furthered by the Act's provisions, propose to not interpret them as economically inappropriate, and then subject the proposed interpretation to notice and comment. We note that this negative approach to defining the scope of the hedge exemption is consistent with the federal financial regulators' (including the CFTC) approach to the Volcker rule's hedge exemption which provides for a flexible standard but also specifically carves out transactions found to be inappropriate to the reduction of a bank holding company's legitimate risks.[187]

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[185] To clarify, the enterprise marketing the production would also "control" the venture's trading.

[186] The CFTC's Hedging Definition Development and Contemporary Issues, Blake Imel, Ronald Hobson, and Paula Tosini, Working Paper Series #CSFM-119, Oct. 1985, citing 17 C.F.R. 33.6(c) (1984).

[187] The Volcker rule's hedge exemption provides that "generalized risks" based on "non-position-specific modeling or other considerations" cannot serve as the basis for the hedge exemption. Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds, Dec. 10, 2013, pp. 345-346*, available at* http://www.sec.gov/rules/final/2013/bhca-1.pdf. Moreover, general market movements or broad economic conditions, profit in the case of a general economic downturn, counterbalance revenue declines generally, or otherwise arbitraging market imbalances unrelated to the risks resulting from the positions lawfully held by the banking entity are further examples of transactions that would not conform to the Volcker rule's hedge exemption either. *See Id.*

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D. *The Commission should reject the Proposal's interpretation of the "substantial relation test"*

The Proposal's cross-commodity bona fide hedging exemptions are conditioned on a "substantial relation" between the price risk source commodity and the commodity in which the price risk is hedged. The Proposal sets forth a two-part, non-exclusive safe harbor for satisfying the "substantial relation" test consisting of a qualitative and a quantitative "factor."[188] As an initial matter, we note that the safe harbor, similar to the exemptions included the 2013 Aggregation Proposal, should not be described as a safe harbor at all because it includes embedded standards that if not satisfied, effectively render non-compliance a de facto violation without true recourse.

The Commission should not accept the Proposal's cross-commodity requirements because commercial realities make the strict application of the proposed quantitative factor inappropriate. The Commission should not accept the Proposal's attempt to judge cross-commodity hedges based on the theoretical standard of an ideal hedge,[189] but rather recognize that the economic circumstances prevailing at the time that a hedge is established and the hedging options then available greatly impact hedge-effectiveness. There are numerous instances where a cross-commodity hedge may be "economically appropriate" but may fail to demonstrate the long-term close correlation the Proposal seeks to adopt as a standard as discussed below:

1. *Correlations vary depending on maturity and the source of price discovery*. For example, a cross-commodity hedge based on correlations in the spot market may only be relevant for spot period hedges. It is also appropriate to consider a hedge to be a cross-commodity hedge when there is a strong correlation between the futures or forward deferred cash prices of the commodity being hedged and the price series of the cross-commodity derivative contract that is to be used for hedging.

2. *Correlations vary based on supply and demand factors*. For example, under certain circumstances, correlations may come closer depending on economic conditions for relatively short time durations, during which a cross-commodity hedge would provide excellent risk reduction value.

3. *Liquidity costs*. For example, under certain circumstances, a closely correlated hedging instrument may be thinly traded and may result in liquidity-related costs for the prospective hedger. Under these circumstances, these liquidity costs may outweigh the benefit of

[188] Qualitative factor: that a "reasonable commercial relationship" between the price risk source commodity and the commodity in which the price risk is hedged (e.g., sorghum and corn, but not Dow Jones Index and crude oil). Quantitative factor: that there is 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 (or R-squared of 0.64) for a time period of at least 36 months. 78 Fed. Reg. at 75,716, 75,717.

[189] We note, for example, that even a small correlation between the price risk and hedging instrument is still risk-reducing (and reduces price risk more so than not hedging the underlying price risk).

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having a hedge that is more closely correlated with the price risk. Under these circumstances, a more liquid but less closely correlated hedging instrument may be "economically appropriate."

1. The Proposal's finding of no "substantial relation" between natural gas and power prices is flawed

The Proposal suggests that there is a weak correlation between the spot price of power and the spot price of natural gas. The Commission's analysis is flawed because the spot price of power is driven, in large part, by short-term changes in the physical conditions of the electric system, which would inherently not be captured in the price of natural gas. However, in the forward markets, the price of power is mainly driven by the price of the fuel (usually, natural gas) used by the marginal power generator as well as that generator's level of efficiency. This forward relationship is evident in the strong correlation between the (forward looking) daily settlement prices of electricity and natural gas futures contracts, and is further underscored by the frequent industry practice of hedging the price of power with natural gas futures.

The Commission's attempt to reject a bona fide commercial risk reducing practice in the Proposal through prescriptive standards only proves the point that flexibility is needed in regulating any aspect of derivatives trading. It is a common and commercially accepted practice to hedge the forward price of electricity with natural gas. In the long term, the price of fuel inputs, such as natural gas, are the primary elements of the price of electricity; near-term factors such as weather, electric system load, transmission, and generation conditions are unknown so far in advance. When considered over the long term, natural gas futures prices and power futures prices are, on average, highly correlated ($R > 0.80$). As the time of generation and consumption approaches, the complex dynamics that contribute to settlement prices in the electric spot market mean that spot electricity prices do not always correlate well with natural gas spot prices. Specifically, prices in the day-ahead and real-time electricity markets ("Electric Cash Markets") are driven by many physical and financial variables which can lead to dramatic fluctuations in power prices. Indeed, this uncertainty is a major reason why market participants hedge the price of electricity. It should be noted that during short-term high demand periods in summer and winter, the short-term power and natural gas markets can show high correlations. The strong correlations during high demand periods is explained by natural gas generation which is frequently on the margin of the Independent System Operator/Regional Transmission Organization (ISO/RTO) generation resource ranking in the day-ahead and real-time markets when base load coal and nuclear generation is not adequate to serve forecasted and actual load.

In addition, structural differences between the natural gas and power markets provide another explanation for the weak correlation between natural gas and power as delivery approaches. Trading of natural gas futures concludes on the last business day before the delivery month, while power futures are traded into the delivery month. This means that the price of power futures within a delivery month can incorporate additional information which was not known when natural gas trading concluded.

2. Background on power prices

Electric prices in ISO/RTO markets, called locational marginal prices, are set by calculating the cost of producing the next megawatt hour. There are two main drivers behind generator bidding of the energy component of locational marginal prices: the cost of fuel which the marginal generator would

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burn (generally, natural gas) and the marginal generator's heat rate, a measure of its efficiency. The heat rate of the marginal generator ("Market Heat Rate") generally can be anticipated by load forecasts—generally, more demand for electricity means that a less efficient electric generator will be on the margin, while less demand for electricity means that a more efficient generator will be on the margin. Electric system conditions can also affect the heat rate of the power generator on the margin. Once a hedger anticipates the market heat rate, the major variable driving electricity prices is the price of fuel, hence the common practice of using natural gas futures to hedge electricity prices.

3. CME's analysis indicated that gas is the main driver of electricity prices

There is a strong correlation between the price series for natural gas futures and power futures. Our analysis found strong correlations, on average, between natural gas futures (NYMEX Henry Hub physically delivered futures) and prices of futures in the Electric Reliability Council of Texas' (ERCOT's) North Hub[190] (R = 0.80), the Independent System Operator of New England's (ISO-NE's) Mass Hub (R = 0.84) and PJM's Western Hub (R = 0.81). CME Group calculated these correlations by examining 49 consecutive futures contract months (January 2010 through January 2014) for each of the three electricity contracts and the Henry Hub natural gas contract. First, we determined the rolling 30-day correlation between the same contract months of a given power futures contract and the Henry Hub futures contract. Next, we computed for each contract month the average 30-day correlation between a given gas-power future contract pair. Lastly, the overall correlation for a given electricity market was calculated as the simple mean of the average monthly gas-power correlations for that power market. The price series for each electricity contract month was truncated and did not include the spot-month. Because a natural gas futures contract ceases trading on the last business day preceding the contract month, the two price series needed to be aligned. Including additional natural gas futures prices would be incorrect as they would be referencing natural gas prices in the calendar month after the electricity is generated.

These strong correlations are explained by the fact that natural gas is the "marginal fuel" in most ISO/RTO electric markets. That is, power generation fueled by natural gas generally determines the price at which electricity clears the markets. According to the respective market monitors of the ISO/RTOs in 2012, natural gas-fired generation set electricity prices 83% of the time in the New York Independent System Operator (NYISO), 81% in ISO-NE, 75-80% in the California Independent System Operator (CAISO), 54% in the Southwest Power Pool (SPP), 54% in the Midcontinent Independent System Operator (MISO), 45% in ERCOT, and 26% in PJM.[191] These numbers are expected to grow even higher, especially in PJM and MISO, as new Environmental Protection Agency (EPA) regulations force

[190] While the Commission studied gas-power correlations at ERCOT's Houston Hub, the Exchange thought it more appropriate to examine correlations at ERCOT's North Hub as it is the most heavily traded hub in the country for physical power, according to Platts' Power Sales Analysis.

[191] For ISO-NE, NYISO, MISO, PJM, and SPP, the percentage of hours in which natural gas was on the margin was taken from the respective market monitor's State of the Market Report. For CAISO and ERCOT, the statistics were provided by communications with each ISO's respective market monitor.

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coal plants to retire, likely causing natural gas-fired generation to take their place.[192] In ERCOT, natural gas continues to be the leading fuel driving power prices. In contrast, an alternative power source, wind generation set power prices over 9% of the time.

The Proposal's assertions that power prices may be driven by other fuels such as nuclear and hydro are unsupported by studies performed by market monitors of the ISO/RTOs, as power generation from these fuels is very rarely or never at the margin. Coal is sometimes a marginal fuel in certain markets, but its role as a price setter is waning as environmental regulations force retirements in coal-fired generation. The Proposal also asserts that power prices may be driven by other factors, such as transmission and power generation outages. While electric system conditions undoubtedly have short-term effects on power prices, these factors are not relevant for a market participant interested in a long-term hedge. Furthermore, much transmission and outage information is considered nonpublic and may not be shared with power traders, as per the Federal Energy Regulatory Commission (FERC) Standards of Conduct. Therefore, trading power based on electric system conditions is not a viable method for hedging power prices and provides no rational basis for the Proposal to conclude that natural gas and power prices have no substantial relationship.

4. Natural gas is the best practical hedging instrument in many power markets

The role of natural gas as the main price component of forward electricity means that natural gas futures are often the best method of hedging for electric market participants without a liquid power futures market in their respective region. For example, for a utility that purchases electricity in a region without an active power futures market, the best method of hedging electric spot prices often is buying natural gas futures (either at the Henry Hub or a local gas price), based on an expected market heat rate to account for the efficiency of electric generation. Likewise, an electric generator without a local power futures market could hedge their costs and revenues with.

As demonstrated by the above analysis, determining cross-hedge efficacy is not a simple matter, and certainly not amenable to strict rules-based standards tied to the concept of an ideal hedge. Cross-hedge analysis is nuanced and inherently involves the flexible interpretation of prevailing market conditions. The Commission is not well placed to pass judgment under such circumstances. We urge the Commission to reject the Proposal's attempt to prescriptively govern yet an additional aspect of bona fide hedging particularly because the Commission is not well-positioned to do so.

E. The Commission should clarify its orderly trading requirement

[192] The Environmental Protection Agency's emerging regulations on hazardous air pollutants, combustion residuals, mercury, and cooling water are expected to force 59 to 77 gigawatts (GW) of coal-fired capacity to retire over the next five years, according to a November 2013 study by the Brattle Group. The report anticipates that the retirements would be replaced by gas-fired generation, given the abundant and low cost supplies coming from the Marcellus. Most of the retirements are expected to be concentrated in PJM and MISO. PJM has already announced the retirement of 20 GW of coal-fired generation and Brattle expects 14-21 GW of additional generation to retire, while MISO has already announced 5 GW of retirements and Brattle expects an addition 11-16 GW to retire.

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The Proposal would require that bona fide hedging positions be established and liquidated in an orderly manner and in accordance with sound commercial practices. We urge the Commission to clarify that the scienter standard for running afoul of this requirement would require intentional or reckless disregard for the orderly execution of trades, consistent with the standard for disruptive trade practices.[193] The Commission itself seemingly equates "its policy regarding orderly markets for purposes of the disruptive trading practice prohibitions, to its orderly trading requirement for purposes of position limits."[194] There is little rational for the Commission to subject a bona fide hedger liquidating a hedge position to a stricter liability standard than would be applied to any other trader that may engage in a disruptive trading practice.

F. The Commission should not preclude recognizing a risk management exemption for positions hedging financial risk

The Commission should preserve the risk management exemption because its elimination is based on the Proposal's reading of the Act in a manner that is contrary to administrative precedent and furthers none of the public interest purposes of the Act. The Commission should preserve this exemption under section 4a(a)(7) of the Act. Moreover, the Proposal is incorrect in interpreting of CEA section 4a(c)(2) as compelling the Commission to omit the risk management exemption.

1. The Commission should not accept the Proposal's interpretation of CEA section 4a(c)(2) as compelling the elimination of the risk management exemption

Commission staff historically provided a bona fide hedging exemption for positions that offset risks related to swaps or similar OTC positions involving both individual commodities and commodity indexes ("risk management exemption").[195] These exemptions were subject to specific conditions to protect the market, including: (1) the futures positions must offset specific price risk; (2) the dollar value of the futures positions must be no greater than the dollar value of the underlying risk; and (3) the futures positions must not be carried into the spot month.[196] Similar exemptions are offered under DCM rules.[197]

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[193] CEA section 4c(a)(5), 7 U.S.C. § 6c(a)(5).

[194] 78 Fed. Reg. at 75,707.

[195] "Position Limits and the Hedge Exemption, Brief Legislative History," Testimony of General Counsel Dan M. Berkovitz, Commodity Futures Trading Commission, July 28, 2009, *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/berkovitzstatement072809.

[196] *Id. See also* CFTC Form 40, Part B, Item 3 and Schedule 1 (defining "hedging" as including "asset/liability risk management, security portfolio risk, etc.").

[197] *See, e.g.*, NYMEX Rulebook, Rule 559.B, *available at* http://www.cmegroup.com/rulebook/NYMEX/1/5.pdf.

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The Proposal seeks to eliminate the risk management exemption on the basis of CEA section 4a(c)(2)'s definition of a "bona fide hedging transaction or position" as added by the Dodd-Frank Act.[198] Section 4a(c)(2) of the Act, as discussed above, was modeled on Commission rule 1.3(z)(1) with one difference: the CEA's definition of a "bona fide hedging transaction or position" did not include the term "normally" in presenting the "temporary substitute criterion" which provides that a bona fide hedge position should "normally 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." (Emphasis added.) The Proposal wrongly relies on the omission of this one word to force a fundamental interpretive shift that would require a bona fide hedging position to actually represent a "substitute[] for transactions made or to be made in physical marketing channel."[199] In other words, under the Proposal's recommended interpretation, the hedge position would have to be "a temporary substitute for a cash transaction that will occur later."[200] Recognizing this fundamental and erroneous interpretive shift is critical because it sets the path for the Proposal's additional restrictions on the statutory definition of bona fide hedging. We urge the Commission to reconsider the Proposal's re-interpretation of the omission of the term "normally" in CEA section 4a(c)(2)'s temporary substitute clause and to interpret it as it has been interpreted since 1977 under applicable administrative precedent: as a non-restrictive condition providing further indication that the risks being hedged under the exemption arise from the operation of a commercial enterprise.

In the Commission's 1987 "Clarification of Certain Aspects of the Hedging Definition" ("1987 Clarification"), the Commission provided background on the meaning of the temporary substitute criterion of Commission rule 1.3(z)(1).[201] The Commission there emphasized that it ultimately adopted in 1977 a bona fide hedge definition that included the term "normally"[202] even though it did not propose the term's adoption. In other words, the Commission in 1977 considered the inclusion of the term "normally" as a clarifying adverb logically inferred from a proposed definition that did not even include the term.

The 1987 Clarification also emphasized that the term "normally" was added in response to commenters to "provide *further* indication" that the temporary substitute criterion was *not* to be "construed as a restrictive, *necessary condition* for the bona fide hedging." (Emphasis added.) In 1977, the Commission explained that the intention behind the proposed definition of bona fide hedging was "to set out the basic conditions which must be met by a bona fide hedging transaction or position; i.e. that it must be economically appropriate to risk reduction, such risks must arise from operation of a commercial enterprise, and the price risk fluctuations of the futures contract used in the transaction must be

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[198] The Commission found that risk management exemptions for persons "to offset the risk of swaps that did not represent substitutes for transactions or positions in a physical marketing channel, neither by the intermediary nor the counterparty." 78 Fed. Reg. at 75,708.

[199] 78 Fed. Reg. at 75,740.

[200] 78 Fed. Reg. at 75,686 n. 60.

[201] Clarification of Certain Aspects of the Hedging Definition, 52 Fed. Reg. 27,195, 27,196 (July 20, 1987) ("also providing that the purpose of the proposed temporary substitute criterion.").

[202] *Id.* citing 42 Fed. Reg. at 14,833.

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substantially related to fluctuations of the cash market value of the assets, liabilities, or services being hedged."[203] For these reasons, we urge the Commission to not accept the Proposal's restrictive and erroneous interpretations that flow from the omission of the term normally. Most importantly, we urge the Commission to not accept the Proposal's attempt to justify contravening the plain text of CEA section 4a(c)(2) of the Act by pointing to the omission of the clarifying adverb "normally."

2. The Commission should preserve risk management exemptions even if it continues to read the "temporary substitute" criterion restrictively

Even if the Commission accepts the Proposal's interpretation of CEA section 4a(c)(2)'s temporary substitute criterion, the CME Group encourages the Commission to use its exemptive authority under section 4a(a)(7) of the Act to permit hedging transactions determined by the Commission to be "economically appropriate" to the reduction of risks in the conduct of a commercial enterprise, inclusive of a risk management exemption. This approach would ensure that the Commission does not impose unwarranted costs on market participants and market liquidity that are not necessary or even helpful to deterring excessive speculation and manipulation. Eliminating the risk management exemption would only deter financial intermediation. We note that neither Amaranth nor the Hunt Brothers used the risk management exemption. Indeed, Amaranth and the Hunt Brothers are inapposite to the trading practices envisioned by the risk management exemption.

V. The Commission should revise the Proposal's recommended "intermarket spread" and financial distress exemptions

A. The Commission should expand the Proposal's unusually restrictive intermarket spread exemption

Under proposed 150.5(a)(2)(ii)(B), DCMs and SEFs may provide for an "intermarket spread position" exemption from position limits. "Intermarket spread position" is defined in proposed 150.1 as a long position in a commodity derivative contract in a particular commodity at a particular DCM or SEF and a short position in another commodity derivative contract in that same commodity away from that particular DCM or SEF. This rule would apply to referenced and non-referenced contracts alike.

The intermarket spread exemption comes with two important limitations. First, the Proposal does not include an intermarket spread exemption from federal position limits. Second, DCMs and SEFs are precluded from applying this exemption to physically delivered contracts in the spot month. Pursuant to current Commission rule 150.5, DCMs may provide exemptions from any position limits for, among other things, arbitrage positions inside and outside the spot month.[204] Under this authority, DCMs have provided for an arbitrage exemption that is available for physically delivered benchmark futures contract positions when offset by other physical-delivery or cash-settled contract positions in the same

[203] *Id.*

[204] *See*, *e.g.*, NYMEX Rulebook, Rule 559.C. available at http://www.cmegroup.com/rulebook/NYMEX/1/5.pdf.

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commodity, provided the arbitrage positions are highly correlated.[205] These rules govern the administration of position limits for 19 of the 28 referenced commodity markets and the 471 referenced contracts that are linked to them. For the reasons provided below, we recommend the intermarket spread exemption be allowed in the spot month for physically delivered futures and available as an exemption from federal position limits. For facilitating comparison between existing DCM "arbitrage exemption" rules and the proposed "intermarket spread exemption," we will refer to both as "intermarket spread exemptions."

1. The Proposal's limited intermarket spread exemption lacks a rational basis

The Proposal's recommendation to limit the ability of DCMs and SEFs to grant intermarket spread exemptions for physically delivered benchmark futures positions in the spot month, as well as the inapplicability of the proposed exemption to referenced contracts, lacks a reasoned basis. The Proposal does not review the operative framework of current DCM intermarket spread exemption rules. Nor does the Proposal consider the impact of its limited intermarket spread exemption under the Six Safeguards embedded in CEA section 4a. Because the Proposal has not provided a rationale for its limited intermarket spread exemption rules, the CME Group is unable to submit alternatives that would address the Proposal's concerns in a less restrictive and burdensome manner.

2. The intermarket spread exemption should be broadened

While the Proposal does not provide a rationale for the intermarket spread exemption or the conditions or provisions contained in it, the Commission has in the past provided a rationale for an analogous exclusion from federal speculative position limits for basis contracts, i.e., contracts that price the differential between the same commodity at two different locations. The Commission proposed to exclude basis contracts from speculative position limits because they "price the difference between the same commodity in two different locations and not the underlying commodity itself."[206] Similarly, an intermarket spread position results in an exposure to the price of the same commodity at different locations and does not result in a discrete outright exposure in the commodity underlying a referenced contract.

For the same reasons underlying the Commission's basis contract exclusion, the Commission should provide for a broad intermarket spread exemption to encompass physical-delivery positions in the spot month and federal limits. Indeed, the price exposure created by a basis contract position is economically identical to the exposure created by an intermarket spread position (e.g., long commodity A in location X and short commodity A in location Y). It is incongruent therefore that basis contract positions should not be subject to speculative position limits while arbitrage or intermarket positions are subject to speculative position limits.

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[205] CME Group, Dodd Frank Position Limits & Exemptions, September 19, 2012, *available at* http://www.cmegroup.com/education/files/dodd-frank-position-limits-exemptions-metals.pdf.

[206] 75 Fed. Reg. 4,143, at 4,153.

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3. The intermarket spread exemption should be allowed in the spot month

We recommend that the Commission reaffirm in DCMs the discretion to apply their knowledge of individual commodity markets and their judgment, as to whether allowing intermarket spread exemptions in the spot month for physical-delivery contracts is appropriate. Cross-market arbitrage in the spot-month across physical-delivery contracts facilitates price discovery across different trading venues with the same underlying commodity (i.e., commodity deliverable under a physical-delivery contract's terms).

As discussed above in section IV, price convergence in physical-delivery contracts ultimately happens at expiration. During that spot month it is therefore important to have a wide range of commercials, including merchants that can move a commodity from where it is to where it is needed based on price signals. An intermarket spread exemption in the spot month facilitates the convergence of prices during the spot month and should therefore be encouraged. Moreover, such a position poses little threat of excessive speculation (given that a trader's net exposure is a locational basis) or manipulation (given that a trader's exposures are in two different locations that are liquid enough to support a physically delivered futures contract. Finally, allowing for the unfettered applicability of intermarket spread exemptions to cash-settled contracts only does not provide the same price discovery value provided by the unfettered applicability of the exemption to physical-delivery futures contracts.

4. The intermarket spread exemption should apply to referenced contract limits

The Commission should also provide for an intermarket spread exemption from federal limits. As discussed above, an intermarket spread position poses little threat of excessive speculation or manipulation. We note that for the 19 non-legacy referenced commodity markets and 471 contracts for which DCMs currently administer speculative position limits, the intermarket spread exemption has encouraged price discovery across different contracts and trading venues in the same commodity. This exemption is commonly used by commercial firms that engage in regional or international arbitrage trades. This activity aids in price discovery by facilitating the decisions of commercial traders, including merchants, to move a commodity from where it is to where it is needed in response to price signals. The exemption is needed without regulatory impediments.

B. The Commission should further clarify that the financial distress exemption to account for instances of financial distress not contemplated by the Proposal

Proposed 150.3(b) provides for a "financial distress" exemption from position limits. "Financial distress circumstances" are defined to "include situations involving the potential default or bankruptcy of a customer of the requesting person or persons, an affiliate of the requesting person or persons, or a potential acquisition target of the requesting person or persons." While the language of the exemption indicates it is non-exclusive, for added clarity we recommend that ", but not limited to," be added after "include" in order to more explicitly account for financial distress situations that have not been contemplated.

VI. The Commission should reject the 2013 Proposed Aggregation Rules because they are unauthorized and in direct conflict with the CEA and CFTC administrative precedent

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A. The 2013 Aggregation Proposal recommends adopting a "longstanding" Commission aggregation standard that was introduced in ultimately vacated rules in 2011

The Commission's 2013 "Aggregation of Positions" notice of proposed rulemaking ("2013 Aggregation Proposal"), which was voted on by the Commission on the same day as the Proposal, would have a significant impact on the application and enforcement of positions limits.[207] The 2013 Aggregation Proposal consistently and erroneously invokes "longstanding" Commission precedent[208] to equate an ownership interest in a separately organized entity (an "owned entity") with an ownership interest in the owned entity's futures and swaps "accounts."[209] Under proposed rule 150.4(a)(1), which purportedly continues the Commission's longstanding requirement, the positions in accounts of owned entities are attributed successively upward to higher tier entities based on a 10 percent entity-ownership threshold.[210] By doing so, the Proposal effectively equates an owned commercial entity to a commodity pool, and that entity's corporate owners to non-passive commodity pool participants.

Under the Aggregation Proposal, corporate ownership therefore is not only an indicia of trading control or indicative of a potential financial interest in positions held in accounts, but an independent and sufficient basis requiring aggregation absent Commission exemptive relief. By way of example, and as would be implemented by proposed rule 150.4(a)(1), in a corporate structure where 10 percent of C is owned by B, and 10 percent of B is owned by A, all futures and swaps positions held in C's accounts would be attributed upward from C to B, and from B to A.[211] Absent exemptive relief, this result would hold even if the entities do not participate in the same derivatives markets or if A and B do not trade derivatives. By way of a second example, if A owned 10 percent of both B and C, the positions of B and

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[207] Aggregation of Positions, 78 Fed. Reg. 68,946 (Nov. 15, 2013). We have separately submitted a comment on this proposal, also dated February 10, 2014.

[208] The 2013 Proposal is proposing to adopt rule 150.4(b)(2), which is largely similar to proposed rule 151.7(b)(1). Proposed rule 150.4(b)(2) would continue the Commission's longstanding rule that persons with either an ownership or an equity interest in an account or position of less than 10 percent need not aggregate such positions solely on the basis of the ownership criteria, and persons with a 10 percent or greater ownership interest would still generally be required to aggregate the account or positions. However, rule 150.4(b)(2) would establish a notice filing procedure, effective upon submission, to permit a person with either an ownership or an equity interest in an owned entity of 50 percent or less to disaggregate the positions of an owned entity in specified circumstances, even if such person has a 10 percent or greater interest in the owned entity. 2013 Proposal at 68958.

[209] The 2012 proposed aggregation rules stated that in the context of applying the ownership prong to entities, "[s]mall ownership interests of less than 10 percent do not warrant aggregation. A 10 percent or greater ownership interest has served as a useful measure for aggregation, but the Commission has determined relief may be warranted for passive investments."

[210] *See* Position Limits for Futures and Swaps; Final Rule and Interim Final Rule, 76 Fed. Reg. 71,626, 71,651 (November 18, 2011) ("vacated rules").

[211] *See* Aggregation, Position Limits for Futures and Swaps, 77 Fed. Reg. 31,767, 31,776 (May 30, 2012).

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C would be aggregated and attributed to A but not aggregated and attributed to B or C. Absent exemptive relief, this result would hold even if A does not trade derivatives. Applying the 2013 Aggregation Proposal's owned-entity standard for aggregating accounts is particularly alarming because of the Commission's strict liability standard for position limit violations, which can occur intraday.

For the benefit of Commission staff and market participants, the Commission should reject the 2013 Aggregation Proposal's approach to account aggregation and again emphasize, as it did in 1999, that the aggregation exemptions in current part 150, including any additional exemptions that may be adopted, are non-exclusive safe harbors.[212] The 2013 Aggregation Proposal consistently and erroneously invokes "longstanding" Commission precedent to support its inflexible and non-discretionary corporate ownership standard even when the Commission has stated in a prior rulemaking that "its own experience...suggests that the application of any standards concerning position aggregation for speculative limit purposes requires judgment in particular circumstances."[213]

The 2013 Aggregation Proposal appears to recognize this long-standing position of the Commission to some extent by styling its owned entity aggregation exemptions as giving rise to a rebuttable presumption, while simultaneously eviscerating the presumption by providing only one way to prove the presumption wrong—that is perfecting an exemption. As proposed, the owned entity exemptions are not exemptions at all. They are strict and novel aggregation requirements that are profoundly unauthorized by section 4a(a)(1). Section 4a(a)(1) requires aggregation based on ownership of positions in accounts or ability to exercise trading control. The Commission, and any other agency operating under a grant of statutory authority, cannot prohibit what a statutory provision permits, without being authorized to, and relying on, another statutory provision to do. The "owned entity" exemptions, as drafted by the 2013 Aggregation Proposal, would require aggregation where an entity can prove irrefutably that: (1) it does not hold any coherent semblance of an ownership or financial interest in derivatives positions (let alone a 10 percent ownership or financial interest); or (2) have any ability to influence the corporate decisions of another legal entity (let alone exercise trading control).

For example, it is more than conceivable that a higher tier corporate entity that does not trade swaps and, through a chain of 10 percent corporate ownership interests, is four tiers removed from a lower tier corporation hedging commercial risks with swaps, can prove irrefutably that it does not have any ownership or financial interest in swaps or the ability to exercise trading control over the corporation that utilizes swaps to hedge commercial risk. That the owned entity exemptions would block position attribution upward only upon perfecting the exemptions proves that they are not exemptions at all, but strict and novel aggregation standards that are profoundly unauthorized by CEA section 4a(a)(1). For these reasons, in addition to being unwarranted, the Proposal's owned entity "exemption" requiring the aggregation of positions is not capable of being authorized by CEA section 4a(a)(1) because it would require aggregating positions when an entity neither owns nor controls derivatives positions.

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[212] Revision of Federal Speculative Position Limits and Associated Rules, 64 Fed. Reg. 24,038, 24,045 (May 5, 1999) ("1999 Revisions").

[213] *See* Establishment of Speculative Position Limits, 46 Fed. Reg. 50,938 (Oct. 16, 1981).

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B. The Proposal may include recommended amendments that seek to enforce the 2013 Aggregation Proposal's assertion that the owned entity standard for account aggregation is a longstanding Commission requirement

The Proposal's amendments to Commission rule 17.00 appear to be an attempt to change large trader reporting rules to require reports based on corporate ownership, not control. Although the owned entity standard for aggregation was introduced in 2011, it is crucial and central to the Proposal's position limit framework and its recommendation for applying limits and hedging standards on an enterprise-wide level. To accomplish this, the Proposal seemingly recommends amendments to the standards for reporting positions under the Commission's futures large trader reporting rules that may require routine position reports based on corporate ownership. The Commission must ensure that this amendment is not permitted. As the Commission stated in 1999:

> Compliance with the Commission's speculative position limit rules is often dependent upon the proper aggregation of positions. A central feature of the proposed rules is the codification of the aggregation standard itself. As the Commission stated in the notice of proposed rulemaking, the requirements relating to aggregation of positions, including the exceptions provided in the Commission's "Statement of Policy on Aggregation of Accounts," 44 FR 83839 (June 13, 1979) (1979 Aggregation Policy), currently are included implicitly in the Commission's large-trader reporting rules. 63 FR 38532.[214]

The Commission's 1999 Revisions also stated that as "discussed in the notice of proposed rulemaking, the Commission's routine large trader reporting system is set up so that it does not double count positions which may be controlled by one and traded for the beneficial ownership of another. In such circumstances, although the routine reporting system will aggregate the positions reported by FCMs using only the control criterion, the staff may determine that certain accounts or positions should also be aggregated using the ownership criterion or may by special call receive reports directly from a trader."[215]

The Commission's large trader reporting system, as it always has done, currently aggregates positions to determine reportable accounts by trading control not corporate ownership. The Proposal's amendments to Commission rule 17.00(b) appear designed to change the standards used to aggregate positions for large trader reports to match the 2013 Aggregation Proposal's owned-entity exemption standards, and support the Proposal's attempt to apply limits and hedging requirements across independent (lacking common trading control) but related corporate entities.

VII. The Proposal fails to conduct an appropriate consideration of costs and benefits and fails to consider existing and less costly alternatives for achieving the goals of CEA section 4a.

CEA section 15(a) requires that the Commission, prior to promulgating regulations under the statute, consider the costs and benefits of its actions. The Proposal's analysis generally fails to appropriately

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[214] *Id*. at 24,043 citing, e.g., 44 Fed. Reg. at 83,839.

[215] *Id*. at n. 26.

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consider the costs and benefits of its proposed rules, including but not limited to a failure to quantify costs that can be quantified. In many instances, the Proposal fails to identify particularly inappropriate and burdensome requirements as discretionary, i.e., the costs are attributable to the proposed rules, and not to a directive in the statute. In doing so, the Proposal circumvents responsibility for conducting an appropriate analysis of the costs and benefits of the Commission's proposed rules as required by CEA section 15(a). The Proposal also fails to consider many obvious and "reasonable alternatives," grounded in its own administrative precedent, to its burdensome proposed rules without an explanation as to why it did so.[216] Several critical examples of the Proposal's flawed consideration of costs and benefits are discussed below:

- With respect to its discretionary approach to spot-month position limit levels, the Commission fails to consider the costs and benefits of imposing spot month position limits that reflect outdated estimates of deliverable supply (as it has done). This is despite the fact that such limits would be unduly restrictive under the Commission's own historic approach to approving DCM spot-month limit levels (i.e. approving such limits when they are set at 25% of up-to-date estimated deliverable supply). The Commission has also failed to properly consider the relative costs and benefits of alternative, more up-to-date spot-month limits contained in the proposal.

- With respect to its wholly discretionary proposed "conditional limits," the Commission bypasses serious discussion of the costs and benefits of its approach with logically incoherent premises and sleights of hand. The Proposal similarly fails to consider an alternative approach, based on parity levels for physical-delivery and cash-settled contracts. This is despite the fact that parity levels have been in place with no adverse effect for 27 of 28 of the referenced contract, and commodities for decades such an approach was affirmed as recently as 2011. The Commission fails to consider this aspect of the Proposal in light of, among other things, considerations of efficiency and competitiveness of futures markets, as well as considerations of price discovery, as required under CEA section 15(a)(2)(B) and (C).

- With respect to the cumulative effect of the Proposal on physical-delivery benchmark futures contracts, the Commission altogether fails to consider the myriad discretionary burdens this rulemaking would impose on such contracts, their price discovery function, and the market participants who rely on the benchmark contracts' continued viability for risk management and trading purposes. The Commission fails to consider this aspect of the Proposal in light of, among other things, considerations of price discovery and sound risk management practices, as required under CEA section 15(a)(2)(C) and (D).

- With respect to its wholly discretionary non-spot-month position limit levels, the Proposal has adopted a formula that is arbitrarily restrictive and has failed to consider the costs and benefits of limits based on this formula for each specific market, despite the evident disparate impact of these arbitrary limit levels. The Proposal also fails to consider the merits of alternative approaches, such as reliance on exchanges to establish such limit levels, federal or exchange set position accountability rules (the latter being the status quo) in lieu of arbitrarily restrictive non-

[216] *See Am. Gas Ass'n v. Fed. Energy Regulatory Comm'n*, 593 F.3d 14, 19–20 (D.C. Cir. 2010) (quoting *Chamber of Commerce v. SEC*, 412 F.3d 133, 145 (D.C. Cir. 2005)) (internal quotation marks omitted).

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spot month position limits, or higher non-spot-month limits that would not deter beneficial hedging and trading activities.

- With respect to its impact on commercial market participants, the Proposal would categorically eliminate non-enumerated bona fide hedging exemptions and thereby significantly undermine the statutory protection of bona fide hedging in the CEA. The Proposal's narrowed bona fide hedging exemption would therefore treat "sound risk management practices" engaged in by commercial firms as speculative and thus subject such non-speculative commercial activity to speculative limits, deterring such risk management practices without considering the costs and benefits of doing so as mandated by, among other things, CEA sections 15(a)(2)(A) and (D). In contrast, if the Commission had adopted an alternative bona fide hedging exemption consistent with CEA section 4a(c)(7) or the Commission's previous section 1.3(z), the cost of limits on such sound risk management practices could have been avoided.

- With respect to the Proposal's effects on DCMs and SEFs, the proposal ignores many costs that would follow from its provisions. For example, the Proposal ignores the costs and benefits of the effect its prescriptive bona fide hedging and aggregation requirements would have on DCMs imposing such requirements for non-referenced contracts subject to DCM or SEF position limits or accountability rules. Similarly, the Proposal ignores the impact of requiring DCMs to impose its prescriptive and resource-intensive aggregation rules and related administrative requirements on non-referenced contracts. These requirements would have considerable impact on the efficiency and competitiveness of futures markets, as well as creating unneeded incentives for price discovery to migrate offshore which the Commission is required to consider under CEA sections 15(a)(2)(B) and (C).[217]

- Most fundamentally, the Commission ignores the alternative of deferring more broadly to DCMs and SEFs to tailor position limits levels and position limits-related requirements (e.g., aggregation, bona fide hedging, other exemptions, etc.) to individual contract markets. This is despite considerable Commission regulatory precedent that suggests that exchanges, because of their superior knowledge of individual markets, can most appropriately establish and administer such regimes. The costs of this departure from well-established Commission precedent must be considered in light of all the factors set forth in CEA section 15(a)(2), but this the Commission's Proposal fails to do.

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CME Group thanks the Commission for the opportunity to comment on this Proposal. Should you have any comments or questions regarding this submission, please contact me by telephone at (312) 930-3488 or by e-mail at Kathleen.Cronin@cmegroupcom; Thomas LaSala, Managing Director, Chief Regulatory Office by telephone at 212-299-2897 or via email at Thomas.LaSala@cmegroup.com or Bruce

[217] This also is relevant to evaluating the Commission's Proposal pursuant to the statutory factors that the Commission is required to consider pursuant to CEA section 4a(a)(3)(B)(iv).

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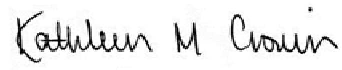
Sincerely,



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