Commodity Markets Council
1300 L St., N.W. Suite 1020
Washington, DC 20005
Tel 202-842-0400
Fax 202-789-7223
www.commoditymkts.org

July 25, 2014

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

Re: **Position Limits for Derivatives, RIN 3038-AD99;**
Aggregation of Positions, RIN 3038-AD82

Dear Ms. Jurgens:

The Commodity Markets Council ("CMC") appreciates the opportunity to submit the following comments to the Commodity Futures Trading Commission (the "CFTC" or "Commission") as part of the reopened public comment period for the Position Limits and Aggregation Proposals surrounding the CFTC Staff Roundtable on Position Limits which was held on June 19, 2014 (the "Staff Roundtable"). CMC is delighted that the CFTC held this public roundtable as the issues surrounding the proposed Position Limits and Aggregation rules have significant impacts on the commodity derivatives markets and especially upon commercial participants and end-users of these markets.

CMC is a trade association that brings together exchanges and their industry counterparts. Our members include commercial end-users which utilize the futures and swaps markets for agriculture, energy, metal and soft commodities. Our industry member firms include regular users and members of such designated contract markets (each, a "DCM") as the Chicago Board of Trade, Chicago Mercantile Exchange, ICE Futures US, Minneapolis Grain Exchange and the New York Mercantile Exchange. They also include users of swap execution facilities (each, a "SEF"). The businesses of all CMC members depend upon the efficient and competitive functioning of the risk management products traded on DCM, SEFs or over-the-counter ("OTC") markets. As a result, CMC is well positioned to provide consensus views of commercial end-users of derivatives on the impact of the Commission's proposed regulations on their commercial operations. Our comments, however, represent the collective view of CMC's members, including end-users, intermediaries and exchanges.

The comments submitted today are a supplement to the comprehensive comment letter submitted to the Commission by CMC on February 10, 2014. This letter is not intended to duplicate the extensive comments already submitted; rather, this letter is intended to further clarify and emphasize several important points discussed at the Staff Roundtable as well as in CMC's February 10 letter.

The fundamental functions of the commodity markets are to allow risk management and price discovery. These markets have evolved over more than 150 years, but have largely been very successful in allowing businesses and consumers to manage risk and have a transparent view of market prices. Thus, it is crucial that the Commission does not harm these integral markets, especially for those commercial and end-user firms which utilize the markets to manage risk. Additionally, a "one size fits all" regulatory approach to all contract markets ignores the distinct and significant differences among the many commodity contracts utilized by commercial participants and end-users for risk management. While no regulatory regime can be perfect, CMC believes the greatest risk to good public policy surrounding commodity markets is in making significant changes to impact a marketplace that is working well already.

1. Deliverable Supply Estimates

CMC requests that the Commission make a determination as to the deliverable supply estimates for each of the twenty-eight physical commodities covered by the Proposed Rule that will serve as the baseline for spot month position limits. Until a proper deliverable supply baseline is established, it will be impossible to assess the appropriate long or short spot month limits that may be set for individual contract markets.

The Commission has received updated deliverable supply data from affected contract markets which CMC believes are conservative estimates. CMC urges the Commission to make an objective economic study of the relevant physical commodities that could be delivered to satisfy relevant contracts upon expiry.[1] As an example, in light of the vast amount of domestic crude production that occurs in the United States as well as the amount of historic import activity, we believe that deliverable supply calculations should include oil production and import capacity beyond merely referencing flows and storage tankage in Cushing, Oklahoma as the only level of "deliverable supply" for the WTI contract.

Additionally, CMC encourages the Commission to analyze physical markets in an objective fashion that is appropriate for each different commodity asset class. As referenced above, the Commission may consider domestic storage capacity, real time production levels and historic import activity for asset classes such as oil and gas. In addition, the Commission should consider refinery capacity when considering deliverable supply for gasoline or other refined products.[2] For grains and soft commodities, storage capacities and flows of the relevant commodity in areas that are in and tributary to the specified delivery points should provide a realistic estimate of deliverable supply.

Upon making objective determinations as to deliverable supply levels in all commodity asset classes, the Commission should allow an appropriate opportunity for the public and market participants to provide comments as to the accuracy of those numbers. With an objective economic study made and public comments received, the Commission will be in a better position to deliberate and decide, if necessary, on the appropriate federal spot month position limit levels for each of the relevant commodity asset classes. Upon establishment of federal limits based on updated deliverable supply estimates, the applicable designated contract markets also will be able to continue to use their discretion in setting exchange specific limits below the federal limits as necessary and appropriate to reduce the potential threat of market manipulation or congestion.

2. Bona Fide Hedging

As discussed at the Staff Roundtable, commercial and end-user firms hedge many types of risk using the commodity derivative markets. The price discovery process of the market aggregates participants' collective expectations of innumerable factors affecting supply and demand, and distills that into an expression of price. Price relationships are critically important, and at times more so than the absolute value of a particular price. As a part of their normal course of business, commercial firms may seek to hedge risks associated with production, quality, currency, interest rates, counterparty, credit, logistics, etc. Moreover, price risk is far more complex than just fixed-price risk, but may include volatility and similar non-linear risks associated with prices. Fundamentally, a transaction to hedge any of these risks in connection with a commercial business should receive bona fide hedging treatment. Many of the participants at the Staff Roundtable discussed the need to fully recognize hedges for unfixed price commitments as bona fide hedges. Several commercial examples were explained during the Staff Roundtable and focused primarily around obtaining hedge exemptions in the spot month for contractual commitments in the months closely following the spot month. Commercial

[1] CMC also urges the Commission to study and consider additional indicia of deliverable supply beyond physical deliverable supply estimates, especially historic swap activity in each commodity asset class in light of the fact that federal position limits will presumably apply to swap activity in addition to futures activity.
[2] The Commission should also consider generation capacity of power plants when reviewing exchanges' deliverable supply estimates and proposed spot month limits for electricity since this is a non-storable commodity.

market practices would be severely impacted if these hedging transactions were not deemed bona fide hedges, and we urge the Commission to allow for such treatment.

In adopting a modern and comprehensive view of risk, the Commission should not condition bona fide hedging treatment as available only when risk crystalizes by virtue of a firm holding a physical position or by entering into a contract. Risk is inherent to commercial businesses, and the Commission should empower commercial and end-user firms to manage risk to the fullest extent possible.

Further, at the Staff Roundtable a question was raised whether capturing arbitrage could truly be a hedge. Commercial enterprises have definite economic risk associated with changes in the value of their commodity asset positions. An enterprise that recognizes this risk being influenced by price relationships of complementary or competing commodities, and executes a derivative position to protect itself from the risk of this asset value change, is being prudent in the operation of the enterprise. Commodity markets allow transparent pricing of commodities with different attributes (e.g. location, grade, quality). The businesses of many commercial and end-user firms rely upon the transformation or transportation of these commodities – which can only be done consistently and efficiently if a firm is allowed to hedge its risk, which oftentimes involves a measure of arbitrage.

- *Anticipatory Hedging, Merchandising, & Processing*

Anticipatory and merchandising hedging are crucial to the risk management functions of commercial and end-user firms and are statutorily recognized as bona fide hedges in the Commodity Exchange Act ("CEA"). Anticipatory hedging allows commercial firms to mitigate commercial risk that can reasonably be ascertained to occur in the future as part of normal risk management practices. Merchandising activity enables producers to place commodities into the value or supply chains and ultimately brings those commodities to consumers with minimal price volatility. Limiting the ability of commercial firms to utilize these crucial risk management tools could result in increased price volatility, lower prices bid to producers, and increased prices that are passed on to end-users and consumers.

In addition, merchandising activity promotes market convergence – which is a crucial aspect of the price discovery function commodity markets serve. A reduction in the efficiency of convergence increases risk, reduces liquidity, and ultimately may lead to both higher consumer prices and lower producer prices. Allowing the full scope of hedging activity promotes more efficient, effective and transparent markets – exactly the public policy goals the Commission wishes to occur.

One topic that failed to surface during the Staff Roundtable was the issue of the anticipatory processing hedge. While the Commission's proposed rule states that such hedges are bona fide, the proposed rule simultaneously extinguishes the utility of the exemption by stating that anticipatory processing positions will only be recognized as bona fide if all legs of the processing hedge are entered into equally and contemporaneously. Hedging is based on human assessment of risk at any given time. Sometimes it is best to hedge just one leg of a processing exposure. The proposed parameters around the processing hedge exemption not only fail to recognize market dynamics; worse, they put the Commission in the position of defining risk and mandating how that risk must be hedged in the market.

- *Economically Appropriate Risk Management Activities*

Language contained within the Proposed Rule[3] suggests that a bona fide hedge only exists when the net price risk in some defined set is reduced. This is inconsistent with the manner in which a commercial firm evaluates risk – which is not limited to price risk, as mentioned above. The most appropriate way to deem a derivatives transaction as "economically appropriate" is whether a commercial firm has a risk abated by the transaction, and such risk arose in its commercial business. Linking the ability to engage in bona fide hedging to a net reduction in risks across an entire enterprise, corporate family, or

[3] Proposed Rule at 75709.

separately-managed lines of business is not consistent with how commercial firms commonly address risk. Moreover, individual firms identify which risks they want to accept. A transaction that may be risk reducing on one side of a business, but leave an opposite risk unhedged in another part of the business might serve legitimate business purposes. Thus, to impose a "net price risk" formula across a corporate group for purposes of bona fide hedging effectively replaces a commercial firm's business judgment with regulatory prescription.

- *Non-Enumerated Hedges*

Non-enumerated bona fide hedges are important to commercial market participants, as they allow additional flexibility for firms to hedge risk in ways that are unforeseen. However, the ability to utilize these non-enumerated hedges is often dependent upon utilizing the hedging strategy in real time in response to fluid market conditions. Specifically, as discussed at the Staff Roundtable, merchandisers and other intermediaries (physical, financial and risk, among others) play a vital role in helping end-users understand and ultimately reduce their risks. To the extent that these merchandisers and other intermediaries are unable to get exemptions for the hedges they require to provide these services, risk mitigation will be reduced and overall systemic risk will increase. Therefore, CMC supports allowing market participants to engage in non-enumerated hedging activity subject to a reasonable review period similar to that contained within current CFTC Regulation 1.47. In addition, as mentioned at the Staff Roundtable, the expertise of the exchanges should continue to be drawn upon by the Commission to allow a timely review of these petitions in the most efficient manner for the Commission.

- *Cross-Hedging*

Cross-hedging is another important hedging tool for commercial participants, and is particularly important for commodities which may be processed or transformed into products which may not be traded commodities. CMC suggests that commercial firms be granted the discretion to determine what relationships between two positions are correlated sufficiently to be considered "substantially related." The Commission should not advance a bright-line test in this respect. The decision to use a cross-hedge is multifactored, and commercial businesses have a natural profit incentive to achieve as great a correlation as possible. However, a set degree of correlation is not always achievable, and sometimes risk managers are limited in their selection to what products are available. CMC members believe that a position limits regime where risk managers can freely select their cross-hedges, report them as such, and stand ready to explain them to the Commission if necessary is the proper regulatory design.

Additionally, CMC urges the Commission not to impose an arbitrary deadline upon which market participants engaged in cross hedging must exit their hedges in the spot month, near month, or in the last five trading days. DCMs should be permitted to set restrictions on a contract-by-contract basis, recognizing the unique characteristics of each individual commodity and contract, and the need (or lack thereof) for commercial end-users to continue to utilize cross-commodity hedges in a specific market during the spot month, near month, or in the last five trading days.

- *Gross and Net Hedging*

CMC continues to request that the Commission allow end-users to utilize both "gross hedging" and "net hedging" concepts when managing risk. The Commission uses concepts of both "gross hedging" and "net hedging" in its discussion of the economically appropriate requirement, but these terms are not separately defined and the context in which they appear does not fully inform their meaning. CMC understands gross hedging to be the practice of separately hedging each of two or more related positions. Net hedging happens when that firm nets its cash purchase and sale contracts to a net long or short position and then offsets that risk by entering into short or long derivatives transactions, respectively. It is crucial that the Commission affirm that each of these methods entail derivatives that would be eligible for bona fide hedging treatment. Additionally, when utilizing gross hedging,

firms should have the flexibility to hedge either the gross long or the gross short when this is the most economically appropriate risk management position.

- *Wheat Equivalence Determinations*

CMC echoes the comments made at the Staff Roundtable to maintain equality between three U.S. Wheat markets: CBOT, KCBT and MGEX. Currently, each market has the same spot month limit and the same single-month and all-months-combined limit. Regardless of the level at which these limits are set, parity should be maintained among these three markets. Different limits for the same type (but not necessarily variety) of commodity could dramatically impact the growth or potential for risk mitigating strategies between the contract markets. In the case of wheat, this is particularly critical given the nature of the three differing varieties. Having three varieties provides not only additional opportunities for market participants to reduce risk through spread trades, but also provides opportunity for hedging and risk management by commercial participants between markets in response to domestic or global economic factors.

3. Trade Options

CMC again urges the Commission not to categorize trade options as referenced contracts subject to position limits. These physical options, including physical forward transactions with embedded volumetric optionality, are an important tool in physical commodity markets. Trade options may be used to manage, among other things, supply chain risk, price risk or both. Subjecting these products to federal position limits could severely harm the efficient operation of physical commodity markets and increase costs for end-users.

Trade options do not trade like physical futures and cannot simply be traded out of or unwound prior to the spot month. In the spot month, a trade option that does not qualify as a "bona fide hedging position" could only be offset with another physical position to bring the net position within the applicable position limit. Taking on a physical position in order to offset a trade option for position limit purposes could introduce new risks to the market participant and would undermine the entire purpose the market participant entered into a trade option in the first place. Such a result would be extremely disruptive to the physical markets.

The burden on market participants associated with speculative position limits on trade options would be substantial. Market participants would be required, for the first time, to track trade options separately from spot and forward contracts, develop systems to calculate the futures contract equivalents for these physical-delivery agreements, and, ultimately, monitor trade option positions for compliance with applicable limits. CMC is unclear as to what purpose the Commission is trying to achieve or what market-disrupting activity the Commission is intending to prevent with the imposition of these requirements.

4. Aggregation

Much discussion at the Staff Roundtable regarding aggregation focused on the delineation between ownership and control of trading accounts. CMC agrees that this is an important distinction and recommends that the Commission not pursue aggregation of positions only based upon affiliation or ownership. Instead, the Commission should require aggregation of positions where an entity controls the day-to-day trading of a portfolio of speculative positions. Prior to the Staff Roundtable, Commission staff highlighted the possibility of using the independent account controller safe harbor as a model for not requiring aggregation among related companies where there is ownership but not control. CMC applauds this approach and believes it may provide a useful framework for capturing the purposes of position limits while not unduly burdening otherwise separate trading activities.

Towards that end, CMC recommends the Commission adopt an exemption from the requirement that persons under common control ("excluded affiliates") aggregate their positions under certain circumstances described below.

Accounts of entities under common ownership need not be aggregated where the entities are excluded affiliates. An excluded affiliate should be defined as a separately organized legal entity:

> (1) That is specifically authorized by a parent entity to control trading decisions on its own behalf, without the day-to-day direction of the parent entity or any other affiliate;
>
> (2) Over whose trading the parent entity maintains only such minimum control as is consistent with its fiduciary responsibilities to fulfill its duty to supervise diligently the trading of the excluded affiliate or as is consistent with such other legal rights or obligations which may be incumbent upon the parent entity to fulfill (including policies and procedures to manage enterprise wide risk);
>
> (3) That trades independently of the parent entity and of any other affiliate; and
>
> (4) That has no knowledge of trading decisions of the parent or any other affiliate.

5. Conclusion

CMC appreciates the Commission's continued consideration of comments made by market participants both at the Staff Roundtable and in the re-opened public comment period. CMC recognizes the Commission's crucial oversight that fosters transparent, open, competitive and financially sound commodity markets, and reminds the Commission that the commodity markets did not cause the 2008 financial crisis. In adopting a final rule for federal position limits, CMC urges the Commission to continue to be mindful of its role in protecting the longstanding and crucial ability of commercial end-users to utilize commodity derivatives markets to manage risk.

If the Commission fails to act upon the recommendations included within this letter to preserve the crucial risk management function of the commodity markets and instead adopts the Proposed Rule in its current form, the Commission will cause much harm to commercial participants and end-users of these markets through loss of market liquidity and reducing convergence. This would further serve to increase prices to consumers and decrease prices to producers – harming both the American public and the farmers, ranchers, and others who produce commodities. From a public policy perspective, CMC submits that this negative outcome can easily be avoided through principles-based revisions to the current Proposed Rule.

CMC appreciates the Commission's consideration of this letter on this most important subject. Should you have questions regarding this topic or wish to discuss further, please contact me at Gregg.Doud@commoditymkts.org or by phone at (202) 842-0400 x 101.

Sincerely,

Gregg Doud
President
Commodity Markets Council