Copperwood Asset Management LP

December 22, 2014

Mr. Christopher J. Kirkpatrick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581
secretary@cftc.gov

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

Dear Mr. Kirkpatrick:

This letter is submitted on behalf of Copperwood Asset Management LP ("Copperwood" or "we") in response to the recently reopened comment period for the proposed rule issued by the Commodity Futures Trading Commission (the "CFTC" or "Commission") regarding the imposition of speculative position limits on futures, swaps, and option contracts in 28 exempt and agricultural commodities (the "Proposed Rules" or "Proposal").[1] We are pleased to take this opportunity to share our comments with the Commission, and we invite the Commission and its staff to reach out to us in the event that you have further questions or if we may be of assistance in any way.

Overview

Copperwood is an asset manager and active participant in the natural gas and electricity markets. Based on our review of the Proposed Rules, we respectfully urge the Commission to reconsider several aspects of the Proposal in order to avoid significant harm to both markets and market participants. The Proposal, if adopted as a final rule, will result in negative disruption to market structure, via contractions in liquidity and increased volatility, that will ultimately impose new costs on end-users, hedgers, and consumers. In order to avoid that

[1] Position Limits for Derivatives, 78 Fed. Reg. 75680 (Dec. 12, 2013), available on the Commission's website at: http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2013-27200a.pdf.

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unnecessary result, we are submitting this letter to request that the Commission address the following issues, each of which is discussed in greater detail below. We specifically encourage to Commission to:

- Abandon those aspects of the proposal that would impose position limits outside of the spot month and instead use its existing tools – surveillance capabilities, special call authority, and oversight authority of designated contract markets ("DCMs") and swap execution facilities ("SEFs") – to address concerns related to speculative activity outside of the spot month,
- Raise spot month limits to recognize a more realistic calculation of deliverable supply,
- Not impose position limits on financially settled instruments; alternatively, to the extent the final rule would impose position limits on financially settled contracts, subject such contracts to significantly higher limits than those applicable to positions in physically settled contracts, and only include limits for instruments that are settled on the same day as the related physically settled contract,
- Mitigate the adverse impact the spot month limits will have on options that expire during the spot month,
- Not include a prohibition on holding physically settled contracts as a condition of relying on a higher spot month limit for financially settled contracts, and
- Finalize the aggregation rules and hedging definition before attempting to move forward with the position limits Proposal.

I. *Non-spot month limits are neither necessary nor appropriate.*

The Commission has not demonstrated, and cannot demonstrate (due to a lack of useful or reliable data), that position limits will have any positive impact outside of the spot month. Perhaps more important than the lack of reliable data is the fact that the risk of abusive speculation or manipulation outside of the spot month is highly limited. The discipline of delivery, whereby market participants holding long and short positions must be prepared to take and make delivery, respectively, does not apply other than in the spot market. As a result, trading outside the spot month does not cause corners, squeezes, or other congestion that is of concern for market manipulation and other abuses. Recognizing a similar principal, the Commission's

recently adopted disruptive trading rules, adopted pursuant to statutory authority added in Dodd Frank, specifically focus on congestion in the closing period (and not other times in the life of a contract).[2] Therefore, instead of non-spot month position limits, the Commission should focus on (i) enhancing the quality of the swaps market data that it does receive and (ii) continuing to develop its understanding of the changes in market structure that have occurred since the implementation of the Dodd-Frank swaps rulemaking programs.[3] In addition, the Commission should consider measures that will enhance the utility of its existing tools—surveillance capabilities, special call authority, and oversight authority of DCMs and SEFs—to address concerns related to speculative activity outside of the spot month.

II. *Spot month limits for physically settled contracts should be raised to incorporate a global view of available supply*.

Commodity markets are global, and market participants transact in futures and swaps contracts in order to implement global risk management strategies. In its current form, the

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[2] *See* Antidisruptive Practices Authority, 78 Fed. Reg. 31890 (May 28, 2013), available on the Commission's website at: http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2013-12365a.pdf. *E.g.*, "[A] CEA section 4c(a)(5)(B) violation may occur when a market participant accumulates a large position in a product or contract in the period immediately preceding the closing period with the intent (or reckless disregard) to disrupt the orderly execution of transactions during that product's, or a similar product's, defined closing period." 78 Fed. Reg. at 31895.

[3] Intercontinental Exchange, Inc. ("ICE") emphasized a similar point more broadly in their August 4, 2014 letter to the Commission, which we also support: "[T]he energy and agricultural markets have changed greatly since 2011 especially with the transition of energy markets from swaps to futures. As of October 2012, all U.S. energy contracts have position limits. In addition, energy markets have significantly expanded over the past 10 years. Following high energy prices in 2007 and 2008 we have seen increased investment in energy production and transportation. As a result of this expansion, there is increased participation in the energy markets. Given these facts, the Commission should carefully consider any changes to what is a well-functioning market. The Commission should especially consider the potential impact of this proposed rule on the price discovery process, particularly in energy markets. ***We strongly suggest that the Commission wait to see the impact of the existing position limit regime before implementing more changes. This new rule could have a lasting (and potentially irreversible) impact on the U.S. energy market***." See ICE letter at 2 (emphasis added), available on the Commission's website at: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=59962.

Proposal would set spot month limits for physically delivered contracts at 25% of "*deliverable supply*." However, the Proposal does not clearly specify how the Commission intends to calculate deliverable supply, and the Proposal would default to exchange calculations of deliverable supply in the event the Commission is unable to develop its own assessment. Our concern is that the Commission's approach to determining deliverable supply fails to account for the global character of modern commodity and derivatives markets. It is completely unrealistic to conclude that the NYMEX Natural Gas Henry Hub contract (NG) is only relevant for natural gas supplies that are available for immediate delivery at or near Erath, Louisiana. The contract is a global benchmark and is used by market participants in their global risk management programs. Therefore, setting position limits on this contract by taking an arbitrary percentage of an inartfully calculated deliverable supply estimate, without also considering supplies that are available at other major delivery points and pipelines, will result in a limit that is artificially low and restrictive. The Commission should either raise the percentage, modernize its methodology for a deliverable supply calculation, or both.

III. *Financially settled contracts should not be subject to position limits.*

Financially settled contracts are not the economic equivalent of physically settled contracts and should not be subject to position limits. Although there is an observable and important correlation between the price of the two, they are not fungible. Instead, whereas physically settled contracts are a liquidity tool for the physical commodity being traded, financially settled contracts serve as a method for legitimate hedging and do not impact the underlying price of the asset. The price correlation between physically and financially settled contracts is due to the fact that financially settled contracts follow, or are priced based on, the price of physically settled contracts. In addition, historically, financially settled swaps contracts are held into expiration without having any impact on physically settled futures – again, this is because the financially settled trades follow the physically settled contracts, and it is a one-way relationship.[4] As such, position limits for financially settled contracts are neither necessary nor

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[4] It is important not to conflate correlation with causation in considering the difference between physical and financial natural gas contracts. In the past, some have argued that the high correlation between the two is evidence that the contracts are fungible. They are not. The physical futures contract requires one to either make or take delivery or exit the contract. The financial contract can be held to settlement. This is a key difference. So

appropriate and they would not contribute to or advance the Commodity Exchange Act ("CEA") goal of deterring and preventing price manipulation or any other disruptions to market integrity.

To the extent the Commission nonetheless determines to subject financially settled contracts to position limits, it should use a limit that is significantly higher than, and several multiples of, the corresponding limit for the related physically settled contract. In addition, the Commission should ensure that such limits, if they are to apply, would only apply to financially settled instruments that are settled on the same day as the related physically settled contract. Financially settled instruments that settle prior to the settlement of the physically settled contract should not be subject to position limits.

Looking at natural gas, for example, a trader has historically been able to enter into 1,000 physically settled contracts and an unrestricted number of financially settled contracts and over-the-counter positions in the spot month. Since 2010 traders have been limited to 5,000 financially settled contracts on NYMEX and 5,000 NG-equivalent financially settled contracts on ICE in the spot month – a restriction that is already too tight and has arguably contributed to decreased liquidity and increased volatility approaching contract expiry. The Proposal would go even further and would seek to impose a single limit across all of these positions and swaps (as the Proposal would impose aggregate limits that would apply to both futures and economically equivalent swaps positions), dramatically limiting the ability of market participants to transact in these contracts. Accordingly, to the extent the Commission seeks to subject financially settled contracts to aggregate spot month position limits, it should only do so at a significantly higher level in comparison to the limits that it seeks to apply for physically settled contracts.

IV. *The Commission should evaluate the impact that spot month limits will have on natural gas options expiration.*

Options on the natural gas contract (specifically, the LN contract on NYMEX) expire the day prior to the underlying contract expiration, which places option expiration inside the time period where spot month limits are applicable. As currently proposed, the new rules would aggregate option deltas and penultimate contract positions with last day positions for the

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long as the contract has a robust design, which is the case with the NG natural gas contract, the physically settled contract must settle at the price of market indifference, and the financial contract must follow that settlement price.

application of position limits. Option deltas are not static and change based on a number of different factors, most significantly the price of the underlying contract and the time to expiration. As the options approach expiration, the deltas change very rapidly. In addition, the delta calculation can be viewed differently based on different models and model assumptions. The exchanges have recognized this problem in their current limit structure, and as such have exempted penultimate instruments, including options, from the spot month limits (*see*, *e.g.*, the LN, NP, HP, and QG contracts on NYMEX). Subjecting penultimate-day contracts, including options, to a hard limit structure would make managing an option portfolio virtually impossible and would result in a great deal of management, compliance, and enforcement confusion and uncertainty, and such limits would likely render the natural gas options market entirely untradeable. The natural gas market is the only one that we are aware of in which the options expire during the spot month limit window. We submit that financially settled instruments should not be subject to position limits (*see* section III, above). Specifically we believe that the Commission should incorporate the approach that is used by the exchange and not subject cash settled penultimate instruments to spot month limits.

V. *A conditional spot month limit for financially settled contracts should not prohibit positions in the physically settled contract.*

As expressed above, if the Commission determines to subject financially settled contracts to spot month limits, those limits should be significantly higher than, or multiples of, any corresponding limit that would apply to the physically settled contract. In addition, the higher limit for financially settled contracts should not in any way be conditioned on or subject to the trader maintaining no position in the physically settled contract.

Conditional spot month limits for financially settled contracts are disruptive to markets generally, and they become even more disruptive if they disallow the holding of physically settled contracts. While the natural gas futures markets currently have conditional spot month limits in place, market participants are able to allocate additional risk via OTC markets, supplementing futures positions with OTC swaps when the existing exchange imposed position limits are overly restrictive. Under the Proposal, this safety valve would be removed, because OTC swaps and exchange traded futures would both be subject to position limits. The result will be that only small speculators will trade in physically settled contracts, while large

speculators and major liquidity providers will be forced into financially settled contracts. As traders are driven out of the physical market, liquidity for end-users seeking to hedge in physically settled contracts will decrease and there will be a corresponding increase in volatility in the pricing of physically settled contracts.

In addition, the higher limit should not be conditioned on the same trader holding no position in the physically settled contract. Conditional spot month limits that prohibit the holding of positions in the related physically settled contract, as set forth in the Proposal, without permitting risk to be allocated in an alternative way (for example, by entering into OTC swaps), impair the price discovery function of the market (i) at the time that it is most important, the spot month, and (ii) for market participants that rely on it most, end-users seeking to hedge commercial risk.

VI. *The Commission should finalize its aggregation proposal and hedging definition before moving forward with the position limits Proposal*.

The Commission has outstanding proposals on both position limits and aggregation. The position limits Proposal includes a number of problematic changes to the hedging definition and its interpretation. The impact of the position limits Proposal is naturally affected by the outcome of the aggregation proposal and the resolution of the hedging definition and important structural issues in the Proposed Rules. Therefore, in order for market participants to assess the impact of the position limits Proposal, the Commission should first finalize the aggregation rules. The Commission should also finalize its hedging definition so that commercial market participants are able to understand how and when the limits could apply to their own trading activities. After finalizing the aggregation rulemaking and the hedging definition, the Commission and the public can effectively evaluate and consider the impact of the position limit Proposal.

More generally, and as noted above, we believe that the Commission should focus its resources on (i) enhancing the quality of the swaps market data that it does receive and (ii) continuing to develop its understanding of the changes in market structure that have occurred since the implementation of the Dodd-Frank swaps rulemaking programs. Until the Commission has consistent high-quality data and can use that data to understand the evolving structure of the market that it is tasked with regulating, it should not proceed with the Proposal and the

imposition of position limits. The risk of disruption to markets and market participants is too high, with no corresponding benefit.

Conclusion

We appreciate the opportunity to provide these comments and we stand ready to provide any assistance in this process that might be helpful to the Commission.

Sincerely,

/s/ Greg Whalley

Greg Whalley
Copperwood Asset Management LP

Cc:
Honorable Timothy G. Massad, Chairman
Honorable Mark P. Wetjen, Commissioner
Honorable Sharon Y. Bowen, Commissioner
Honorable J. Christopher Giancarlo, Commissioner

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