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January 22, 2015

Via Electronic Submission

Chris Kirkpatrick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Re: **Re-Opening of Comment Period Regarding Commission Agricultural Advisory Committee Discussion of Position Limits for Derivatives (RIN 3038-AD99) and Aggregation of Positions (RIN 3038-AD82)**

Dear Mr. Kirkpatrick:

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 its reopening of the comment period for its proposed rules (1) establishing position limits for derivatives, and (2) amending the rules governing the aggregation of positions.[1]

Introduction

CMC is a trade association that brings together exchanges and their industry counterparts. Its members include commercial end-users which utilize the futures and swaps markets for agriculture, energy, metal and soft commodities. Its industry member firms also 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 DCMs, SEFs or over-the-counter ("OTC") markets. As a result, CMC is well positioned to provide a consensus view of commercial end-users on the impact of the Commission's proposed regulations on derivatives markets. Its comments, however, represent the collective view of CMC's members, including end-users, intermediaries and exchanges.

[1] *See Position Limits for Derivatives and Aggregation of Positions*, 79 Fed. Reg. 71973 (Dec. 4, 2014) (proposed rule, reopening of comment period).

CMC commends the CFTC's recent efforts to understand the effects of its proposed regime for new federal positions limits on the interests of commercial participants in the physical and financial commodity markets. Forums such as the June 19, 2014 end-user roundtable on position limits and the December 9, 2014 Agricultural Advisory Committee meeting, have been productive for such commercial participants to bring their concerns forward. CMC participated in both of these forums and it has submitted comment letters to the Commission regarding its federal position limit proposal.[2] CMC incorporates those comments with this letter. In addition attached for ease of reference is an executive summary of the key points set forth in CMC's prior comment letters.

Position Limits and Properly Functioning Markets

Though not flawless, the federal position limit regime that existed prior to the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") struck an appropriate balance between market protections and flexibility that allowed commercial firms to hedge their risks and manage their commercial businesses. The Commission should be careful not to disrupt the prior balance in modifying and expanding its position limit regime and accepting new, more restrictive interpretations about *bona fide* hedges. The Commission's changes to the federal position limit regime should not constitute overly prescriptive measures that hinder the use of derivatives markets by agricultural firms to manage risks in their commercial ventures.

There are many facets to the federal position limits regime, and the Commission should be mindful how changes to one aspect of the regime might stress other parts of the regime. For example, changes to the deliverable supply determination may result in higher or lower position limits for a given contract. It will be critical for the *bona fide* hedging regime to be effective and appropriate so that firm's risk mitigation activities are not restricted by the changes in position limits as changes occur in deliverable supply determinations. CMC members are concerned that, in the Commission's attempt to revisit almost every aspect of the federal position limit regime, it will not be able to predict the consequences of so many simultaneous changes. An incremental, stepwise approach by which the Commission addresses elements of the position limit regime sequentially would be preferable. But in the absence of such an approach, the Commission ought to double its efforts to ensure its changes to the federal position limits regime do not harm the physical and financial markets for commodities.

[2] September 24, 2013 - http://www.commoditymkts.org/wp-content/uploads/2014/05/CMC-Final-Anticipatory-Hedge-9.24.13.pdf; February 10, 2014 - http://www.commoditymkts.org/wp-content/uploads/2014/05/CMC-Position-Limits-Comment-Letter-2-10-2014.pdf; July 25, 2014 - http://www.commoditymkts.org/wp-content/uploads/2014/07/CMC-PL-Roundtable-Comment-Letter-FINAL.pdf

***Bona Fide* Hedging**

A well-formed definition of "*bona fide* hedging" is essential to the Commission maintaining a proper balance between market protections and the ability of agricultural firms to use derivatives markets in furtherance of their commercial activities. If the definition is too restrictive, it will choke off legitimate hedging activity by agricultural firms. CMC offers the following comments to avoid such an outcome.

The Commission should be mindful that examples of hedging transactions often over simplify how agricultural firms operate and manage risk in the derivatives markets (*e.g.*, one-to-one hedging of purchase contracts and sales contracts). These simple examples, while informative of the enumerated hedges, should not constitute or dictate the criteria of such enumerated hedges. Hedging is often more complex. Agricultural firms often manage risk associated with large portfolios of cash and derivative positions, and come into the derivatives markets to manage operational aspects of their business that extend beyond fixed-price risk. Accordingly, the definition of "*bona fide* hedging" must be robust enough to address the needs of such agricultural firms and not be constrained by an over-simplified analysis of hedging.

The definition of "*bona fide* hedging" must account for what agricultural firms actually do in the derivatives markets, and not be formed solely to prevent potential abuses of the *bona fide* hedging exception from position limits. This tenet is particularly true if the Commission has little evidence of abuse of an enumerated hedge exemption.[3] In the view of CMC members, the discussion of the enumerated hedges has been dominated by concerns around the prevention of any conceivable form of non-hedging activity, at the expense of the needs of commercial firms and without full recognition of how their trading corresponds to the operation of their agricultural business.

Agricultural firms use derivatives to manage the commercial business beyond mitigating fixed-price risk, and often to address reasonably anticipated obligations. Here is an example:

> A local grain elevator anticipates buying grain from a farmer who will have a crop for sale in May, but who does not want to lock in a price too early. The farmer agrees to sell to the elevator at a differential to the futures price (*e.g.,* 3 cents above the May futures price). The grain elevator might hedge its unfixed price risk with long May futures. This could be done before or after agreeing to an unfixed price purchase from the farmer. When the parties agree to decide to "fix" the price of the grain, they engage

[3] The definition of "*bona fide* hedge" establishes two categories of trades: hedging transactions and speculative transactions. Any trade that is not a bona fide hedge is a speculative trade. The mandate of the Commission in formulating and implementing the definition of "bona fide hedge" is to facilitate the use of derivatives markets by commercial firms. It is not to define speculation as expansively as possible. Thus, the Commission should start with a broad interpretation of hedging transactions that qualify for an exemption from federal position limits. Otherwise, the Commission jeopardizes thwarting risk reducing derivatives trading that is neither manipulative nor speculative through definitions or interpretations which expansively classify such trades as "speculative." This result is not in furtherance of any goal related to position limits.

> in an exchange for physical transaction in which the elevator accepts a short May futures position that offsets its hedge.
>
> That same grain elevator also anticipates selling grain in July based on a differential to the futures price (*e.g.,* 5 cents above the July futures price). The grain elevator would hedge the July sale with short July futures. When the elevator and a purchaser decide to "fix" the price of the grain, they enter into an exchange for physical transaction, resulting in the elevator accepting a long futures position that offsets its hedge.

In this example, the elevator uses futures to facilitate its business of accumulating commodities today and for the later sale of those commodities. Yet, if the purchase and sales contracts are priced to index, the elevator is not hedging fixed-price risk as described under the proposed position limits rule. More accurately, it is managing a timing difference between receiving July contracts for commodities for which it will deliver May contracts. Moreover, the elevator may have a reasonable anticipation of volumes over more than one sales contract. It would be unduly burdensome if the elevator had to manage risk associated only with actual sales, and more logical to permit the elevator to manage risk associated with its anticipated sales. The logical futures trade to address this aggregate commercial activity is the calendar spread, but under the proposed definition in CFTC Regulation 150.1, using derivatives to hedge anticipated unfixed-price risk would not count as *bona fide* hedges.

Finally, the Commission should note a shift in recent years of the understanding of *bona fide* hedging by it and the staff of the CFTC (particularly the Division of Market Oversight). In the experience of CMC's members, the interpretation and construction of *bona fide* hedging has narrowed, with a formalistic emphasis on fixed-price risk and a narrower view of anticipatory hedging. CMC members would disagree with those who argue such formalism has always been the accepted interpretation of *bona fide* hedging, or that it is the only permissible interpretation. Rather, this formalism represents a change, and one that creates an overly prescriptive definition of *bona fide* hedging. There is also no convincing support for the proposition that the enactment of the Dodd-Frank Act mandated such an interpretational shift. As a result of this shift, many types of trading in derivatives markets that were long recognized as legitimate hedging by commercial firms and regulators are now no longer afforded *bona fide* hedging treatment.

Congress did not limit the Commission to recognizing only fixed-price risk as the basis for *bona fide* hedging. CMC urges the Commission to style a definition of "*bona fide* hedging" that includes other commercial risks, such as anticipated merchandising risk, risk associated with index-priced physical sale contracts, absolute price risk, spread risk, quality risk, basis risk, and execution risk (including freight and potentially foreign exchange rates) among others. CMC submits it was not Congress's intent to hurt commercial hedgers or prohibit legitimate commercial hedging activity in its attempt to prevent excessive speculation. Accordingly, the Commission should adopt a more reasonable and pragmatic approach to defining hedging.

Recognition of Risk

Firms have pricing risk when they submit an irrevocable bid or offer for a physical transaction because they incur an enforceable obligation. This recognition of risk incurred is consistent with law and modern risk management practices. The Uniform Commercial Code supports the recognition of risk upon the making of an irrevocable bid or offer. UCC Section 2-205, "Firm Offers," makes clear that a merchant is legally bound by the terms of the offer for the time stated in the offer until it is revoked or for a reasonable time, depending on the circumstances.[4] Thus, the Commission should consider hedging of binding bids and offers as a *bona fide* hedge.

Non-enumerated Hedges

The Commission, in issuing a final rule on federal position limits, should address the many concerns about the definition of "*bona fide* hedging" already placed before it by CMC and many other market participants. More specifically, the CFTC should retain its current framework for granting exemptions for enumerated and non-enumerated hedging positions. Under the proposed position limits rule, the process for market participants to apply for non-enumerated hedges may prove untimely and cause uncertainty for market participants wishing to place a hedge in dynamic commodity markets.

Aggregation

The Commission should focus solely on aggregation when a parent entity has control of day to day hedging and trading strategies of the child entity. In the instance of a firm acting on its own behalf without the control of a parent company we believe no aggregation should occur. Monitoring aggregation under the Commission's current proposal would present significant operational challenges. Many firms that would be required to aggregate positions with affiliates do not maintain centralized systems of record keeping, nor do they hedge the same type of risk. Moreover, monitoring by both Swap Dealers and FCMs would require not only additional compliance staffing, but also a robust industry tracking system. There are concerns regarding the robustness of current technological compliance solutions. Before rules are finalized, a system acceptable to the industry should be further vetted and approved to facilitate compliance. CMC's views on aggregation are more fully explained in its prior comment letters and in the attached executive summary.

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[4] Whether a bid or offer is enforceable against the maker is not determined by whether the bid or offer is in writing. *See, e.g.*¸ Scoular Co. v. Denney, 151 P.3d 615 (Co. Ct. App. 2006) (a firm offer in the grain industry "refers to a standing offer by a producer to sell a set amount of bushels, at a set price, for a set delivery date [and] [c]onsistent with ordinary common law contract principles and . . .2-205, this type of oral offer remains open and viable until the producer revokes it"); *see also* In re Grain Land Coop Cases, 978 F. Supp. 1267, 1279 (D. Minn. 1997) (grain contracts "fall squarely within the purview of the U.C.C.").

Conclusion

Thank you for the opportunity to provide comments on the commercial impacts of these rulemakings. If you have any questions or concerns regarding this letter, please do not hesitate to contact Kevin Batteh at Kevin.Batteh@Commoditymkts.org.

Sincerely,

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EXECUTIVE SUMMARY
CMC POSITION LIMITS AND AGGREGATION ISSUES

In addition to the Comment Letter filed on January 22, 2015, CMC submits this Executive Summary of Issues drawn from Prior CMC Comment Letters. CMC's goal is to ensure that its members are able to use derivatives markets to hedge economically-appropriate risks incurred in connection with their commercial operations.

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 upon expiry.

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. 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.

With an objective economic study made (and an opportunity for public comments), 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

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. Commercial 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.

- *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.

Also of concern is 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 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 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, 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 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, 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 business incentive to achieve as great a correlation as possible, and employ risk management professionals and systems to prudently manage risk and identify the most effective hedges. 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.

3. Spot Month and All Month Limits

- *Wheat Equivalence Determinations*

It is critical to maintain equality among the three U.S. Wheat markets: Chicago, Kansas City, and Minneapolis. 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.

- *Non-Storable Commodities*

Storable commodity markets are fundamentally different than continuously produced non-storable commodities. In markets in which the commodity cannot be stored and carried from one delivery period to the next, deliverable supplies in subsequent expiration months are independent from the previous expiration months. Therefore, a reduction in the deliverable supply for the current delivery period does not lead to a reduction of deliverable supply for all subsequent delivery periods, and the prices of related futures contracts are not linked across months by the cost of storage. Therefore, 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. Dairy markets are a primary example of this type of market. In these markets, the commodity is sold upon its production without ability for significant storage of the commodity, and most hedging is done through the trading of strips. So for example, specifying all month limits for Live Cattle, Lean Hogs, Feeder Cattle, And Class III Milk will reduce the liquidity that speculators provide to hedgers in these markets. Also, imposing an all month limit for Class III Milk, would create a disconnect with its products, including cheese, butter, and dry whey, which are often traded as a spread to Class III Milk and have single month exchange limits. For these reasons, in 1993 the Commission deemed the all-months-combined limits unnecessary and found that the benefits of such limits did not outweigh the likely cost of eroding speculative volume and liquidity and the disruption in the efficient functioning of the non-storable commodity futures markets. Inflexible, non-spot-month position limits have no apparent relationship to deterring excessive speculation or manipulation and would be detrimental to liquidity and the ability of agricultural firms to hedge.

4. Trade Options

CMC 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 are generally used to manage, among other things, delivery and supply chain risk. 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.

5. Aggregation

CMC 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. In the past, 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.