March 24, 2015

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

Re: RIN 3038–AD99 Re-Proposal of Position Limits

Dear Mr. Kirkpatrick,

I appreciate the opportunity to comment on this important consideration that ultimately affects producers and consumers of commodities not only in the United States but throughout the world.

Where are the "Excessive Speculators"?

W. Edwards Deming is famously credited with the statement, "In God we trust. All others bring data." Sound advice. In making the case for position limits the commission cites two data points from a sample of 36 years: the first from the silver market in 1979 and the second from the Amaranth implosion of 2006. We would expect that if excessive speculation were present we would have plenty of obvious, statistically significant examples – not just two in 36 years. Instead of being obvious, it is undetectable. If we claim that elephants were playing in the backyard then we would expect to see their footprints. The alleged excessive speculation, if it is taking place, is leaving no data footprints. Even if we accept that market damaging episodes of excessive speculation are taking place we need to insure that the "cure" of the disease of "excessive speculation" does not do more harm than good.

*Primum non nocere*

Notwithstanding the lack of evidence of excessive speculation it may not be imprudent to specify, implement and enforce position limits that might serve to meaningfully attenuate the possibility of adverse market disruptions that could result from *future* excessive speculation provided that the limits do not significantly damage the existing healthy functioning of these markets. The overriding objective must be to "first, do no harm," especially because we are "treating a patient" in whom we are unable to detect even the faintest indication of the disease. This proposed implementation of position limits is pure preventive medicine that we are applying at a time when there is, according to many hedgers, a dearth of speculative capacity in many energy contracts that is driving up the costs of hedging, the cost of which is directly passed on to consumers and producers.

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Preventing Excessive Speculation

Amaranth has been cited as one of the two examples of harmful market disruption from excessive speculation. There is a clear record of Amaranth's trading activity in the absolutely fascinating *Report of the Permanent Subcommittee on Investigations.*[i] Among the positions that Amaranth undertook in 2006 was a short position of 190,000 contracts of natural gas in two adjacent months (September and October 2006). While I agree that 190,000 NYMEX NGs in a two month period is an awfully large position I would suggest that it is a severe over reaction to set limits at the levels proposed by the commission. If two reckless drivers in the past 36 years caused accidents by speeding at 190 miles per hour it would not justify the cost of setting a national speed limit of 20 miles per hour.

Position Limits Set Too Low Will Distort Prices, Increase Volatility, Increase Option Premiums and Increase the Cost of Hedging

It is critical that the commission establish position limits on cash settled contracts that do not further diminish speculative capacity in U.S. energy markets. In the recent Environmental and Energy Markets Advisory Committee meeting on Feb 26 Steve Sherrod, senior economist, Division of Market Oversight at the CFTC presented compiled data that identified the number of traders who would have been affected by the proposed position limits in the calendar years 2013 and 2014 for NYMEX Henry Hub Natural Gas, NYMEX Light Sweet Crude Oil, NYMEX Harbor ULSD and NYMEX RBOB[ii]. The number of unique entities affected were:

- Natural Gas 83
- Crude Oil 44
- ULSD 31
- RBOB 36

Mr. Sherrod characterized these as a "very few traders."[iii]

Notwithstanding Mr. Sherrod's high quality work and expertise these are most certainly NOT a "very few traders." Limiting the largest 83 traders in the Henry Hub Natural Gas contract will introduce unpredictable market distortions. We would also expect the introduction of a bullish bias in the price of natural gas given the increased influence by the non-reportable class of market participants who in the past 780 weeks have been short, in aggregate, precisely once (see Addendum A).

I do not have access to data that reveals how much speculative capacity will be removed from the markets as a result of the proposed limits but I urge the Commission to consider the potential adverse market impact that will result from limiting such a large number of traders from the markets. Specifically, I suggest that the Commission consider a spot month limit of 20,000 lots of natural gas (NYMEX NG and NG Look-alikes) and an all month limit of 100,000 lots.

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Deliverable Commodity Contracts are Fundamentally Different Instruments from Nondeliverable Cash-Settled Contracts.

In the current proposal of position limits the Commission correctly distinguishes between cash-settled and deliverable contracts. Cash-settled contracts never end in anyone making or taking delivery of a commodity – never. One cannot use cash-settled contracts to hoard – you can buy a trillion dollars' worth of cash settled futures, options or swaps and it will not entitle you to take delivery of one thimble full of oil, one spark of electricity or one whiff of natural gas. A cash-settled contract does not create additional demand or additional supply. If carried to settlement a cash-settled contract always ends with one party paying the other party cash.

Option Deltas

This is an extremely important issue, which if left unresolved will cause incalculable damage to the U.S. natural gas markets. 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 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. Such limits would likely render the natural gas options market entirely untradeable. The natural gas market is the only one that I am aware of in which the options expire during the spot month limit window. I submit that financially settled instruments should not be subject to position limits. Specifically I 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.

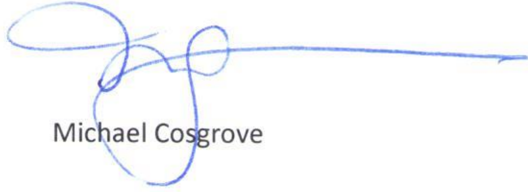
Hedge Exemptions

As I prepared a position on hedge exemptions, I found two submissions already filed that were so well written that I had nothing to add. I am therefor associating myself with the positions articulated by the Commercial Energy Working Group in their letters to the Commission dated Feb 10, 2014 and Aug 4, 2014 and encourage the commission to adopt the suggestions proposed.[iv v]

ETFs Must Be Treated Like FCMs in Respect of Position Limits

Commodity ETFs essentially perform like FCMs that require their customers to deposit the full notional value of the contract. Treating them as anything other than that absolutely defies the clear intent of Dodd-Frank. Such a rule penalizes small investors and increases market leverage. Having said this, I consider the ETF issue to be less critical to the safe, fair and efficient operation of our markets and so I have relegated the ETF issue to Addendum B a as I do not want that issue to distract from the other (in my view) vastly more important issues in this letter.

Yours sincerely,

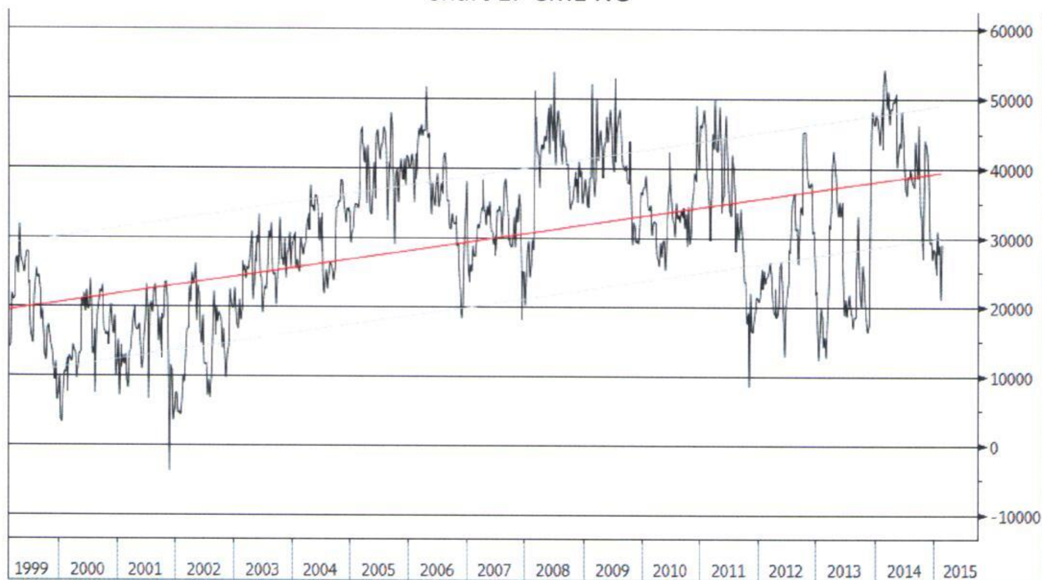


Michael Cosgrove

Addendum A

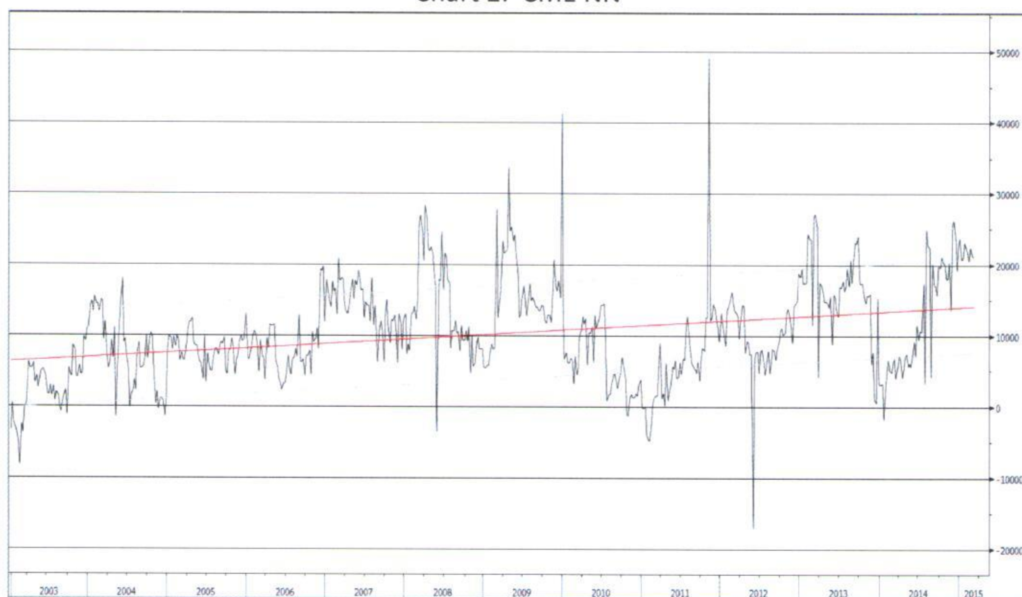
Aggregate Non Reportable Positions

Chart 1. CME NG




This chart displays aggregate non-reportable positions in the CME Natural Gas Contract. In the past 780 weeks this group has been short only one time and, as a group they have become increasingly bullish over this period.

Chart 2. CME NN




This chart displays the aggregate position of non-reportable positions in the CME natural gas cash settled contract (NN).

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## ADDENDUM B

### Treatment of Exchange Traded Funds

ETFs Must Be Treated Like FCMs in Respect of Position Limits

Commodity ETFs such as the United States Commodity Funds operate exchange traded funds "that are designed to track the movements in the prices of different commodity futures." Critics complain that their presence distorts prices because they take and hold long positions for long periods of time. Critics describe them as large monoliths whose presence must be restrained in order to make markets safe for their originally intended beneficiary – the commercial hedger. In his testimony before the Commission on August 5, 2009, John Hyland, Chief Investment Officer of United States Commodity Funds contrasted the monolith characterization with an explanation that his funds provide its approximately 600,000 shareholders with a low cost vehicle for obtaining price exposure to energy commodities. Mr. Hyland reiterated the point that his crude oil ETF was a seller when prices were rising and a buyer when prices were falling demonstrating the impossibility of the assertion that his fund was pushing up crude oil prices.

ETF Shareholders Pay Full Price

While all leverage is not equal (e.g. 20:1 leverage applied to short duration U.S. Government Bonds is very different than 20:1 leverage applied to natural gas futures) there can be little disagreement that one of the largest causes of the near collapse of the global financial markets in 2008 was the extreme level of aggregate leverage present in these markets. If leverage generally had been lower the danger of a financial collapse would have been less. In contrast to highly leveraged energy futures and swaps market participants (which is just about everybody) ETF shareholders pay the full notional value of the commodity represented by their shares in the ETF. I cannot think of another participant in the futures or swaps markets who pays the full price. As such, it is a mathematical certainty that the presence of the commodity ETFs reduces the average leverage employed in the futures markets thereby rendering these markets less volatile and less likely to be a source of systemic risk to the global financial system.

ETFs Are a Vehicle for Small Traders

While they have been described as "massive passives" I believe that they are better described as "mass transit." Exchange traded funds are equity vehicles that enable small investors to gain exposure to commodity prices. A family of exchange traded funds with 600,000 shareholders is the opposite of a large trader with a tightly concentrated locus of decision making. Such a fund is more analogous to an omnibus account. Limiting the size of ETF positions at the entity level contradicts the Commission's intention of encouraging a greater plurality of market participants. Placing an entity level position limit on exchange traded funds would be like the Department of Transportation banning busses and trains because they are too big.

U.S.-Based Long Commodity ETFs Further a Critical Strategic Objective of the United States Government

When someone buys a share of an ETF the ETF manager will in turn buy a proportionate share of a futures or swap position. Who sells that futures or swap to the ETF? It could be another speculator. It could be a producer. It could be virtually any type of market participant. In a market with a sufficiently steep contango and the availability of storage capacity those with access to physical supply and the means of storage could buy the cash commodity, store it and lock in a riskless back-to-back profit by selling the forward futures or swap contract to the ETF buyer. This results in the distant month purchases of the ETF inducing those with the ability to build commercial storage to do so. Such a building of stocks has been a strategic objective of the United States Government for over 35 years. The U.S. Strategic Petroleum Reserve currently holds approximately 700 million barrels of crude oil in salt domes in the Continental United States. It has been argued by Verleger et al. that the presence of the commercial energy stocks accumulated in meaningful measure as a response to the forward long positions held by energy ETFs significantly mitigated a price spike in heating oil in December 2009 and January 2010. Verleger also points out that cash and carry stocks accumulate near delivery points. The implication of this is that by forcing ETFs out of the United States the commercial stocks that they indirectly stimulate will follow them – to the benefit of the new host country.

ETF Summary

- Commodity ETFs are vehicles that allow the small investor to economically gain price exposure
- ETF investors pay the full notional value of the commodity, they employ no leverage
- ETFs reduce aggregate leverage employed in the futures markets
- Since late 2008 ETF investors have had a moderating effect on energy market volatility

Imposing entity level position limits on ETFs is equivalent to the making following statement to small commodity investors:

NOTICE TO ETF INVESTORS: IF YOU WANT TO BUY SHARES OF A COMMODITY ETF IN YOUR STOCK BROKERAGE ACCOUNT AND PAY THE FULL NOTIONAL VALUE OF THE COMMODITY YOU ARE NOT WELCOME HERE. WE SUGGEST YOU COME BACK AFTER YOU HAVE OPENED A PERSONAL FUTURES ACCOUNT AT WHICH TIME YOU WILL BE WARMLY WELCOMED AS A PREFERRED MEMBER OF OUR FUTURES TRADING FAMILY (YOU WILL VERY LIKELY PAY FAR HIGHER FEES FOR EACH TRADE SINCE YOU WILL LOSE THE BENEFIT OF THE LOW EXECUTION AND CLEARING RATES NEGOTIATED BY THE ETF MANAGER AND YOU WILL HAVE TO MANAGE YOUR OWN ROLLS. ON THE OTHER HAND YOU WILL BE ALLOWED TO TRADE WITH A GREAT DEAL OF LEVERAGE).

It seems unlikely to me that this is how the Commission really wants to treat small commodity investors.

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[i] http://www.hsgac.senate.gov/download/report-psi-staff-report-excessive-speculation-in-the-natural-gas-market-6/25/07

[ii] Federal Register / Vol. 80, No. 37/ Wednesday, February 25, 2015/ Proposed Rules. Pages 10025 - 10026

[iii] http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/emactranscript022615.pdf. Page 60.

[iv] *See* Working Group Aug. 4th Letter, *Position Limits for Derivatives, RIN 3038-AD99*

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[v] *See* Working Group Feb. 10th Letter, Sections III.B.1-3.; III.G.; IV.B.; VII.; Working Group of Commercial Energy Firms, *Petition for Commission Order Granting Exemptive Relief for Certain Bona Fide Hedging Transactions under Section 4a(a)(7) of the Commodity Exchange Act* (submitted Jan. 20, 2012), *available at* http://www.cftc.gov/stellent/groups/public/@rulesandproducts/documents/ifdocs/wgbfhpetition012012.pdf ("BFH Petition") (attached hereto as Attachment 2); *see also* The Commercial Energy Working Group, *Request for Exemptive Relief No. 7 for Working Session on BFH Petition* (submitted to S. Sherrod, Senior Economist, Division of Market Oversight, on Sept. 19, 2012, supplementing and amending Request for Exemptive Relief No. 7 of the BFH Petition) ("Revised Request for Exemptive Relief No. 7") (attached hereto as Attachment 3). Note, in February 2012, the Working Group of Commercial Energy Firms reconstituted itself as "The Commercial Energy Working Group."