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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 the Commodity Futures Trading Commission Energy and Environmental Markets 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 on position limits for physical commodity derivatives and the aggregation of positions.¹

I. 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 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, 80 Fed. Reg. 10022 (Feb. 25, 2015) (proposed rule, reopening of comment period).

II. The Proposed Position Limits

The CMC has submitted several comment letters to the Commission regarding its Proposed Position Limits rules.² Rather than repeat prior comments, the CMC would like to use this opportunity to highlight some of the issues raised at the February 26, 2015 Energy and Environmental Markets Advisory Committee (“EEMAC”) meeting and issues related to the new position limits table 11a.

Comments Related to the February 26, 2015 EEMAC Meeting

A. *Bona Fide* Hedging in General

Pursuant to the Dodd Frank Act, position limits are to be used, not to prevent speculation, but only to prevent excessive speculation, to the extent it exists. Dodd Frank was never intended to focus on commercial market participants, such as CMC members, engaging in hedging activity. This is not surprising given that the list of market events that led to the passage of Dodd Frank does not include trading in the agriculture or energy markets, and it certainly does not include allegations of speculative trading by commercial market participants disguised as *bona fide* hedging.

Unfortunately, and perhaps in an attempt to address concerns about how one might disguise speculative conduct as hedging, the proposed rules will curb the practice of hedging by producers, end users and merchants. Merchants play a critical role in the marketplace by, among other things, promoting convergence between the physical and futures markets. Convergence is a crucial aspect of the price discovery function and markets with effective convergence ultimately reduce risk and provide liquidity. Merchants face, accept, and manage several different types of risks in the supply chain. Commercial merchants face countless risks including, but not limited to: absolute price risk, relative price risk (which is basis or unfixed risk), calendar spread risk, time risk, location risk, quality risk, execution and logistics risk, credit risk, counterparty risk, default risk, weather risk, sovereign risk, and government policy risk. It is important to recognize that all of these risks directly impact the commercial operations of a merchant and ultimately affect the value of the merchant’s commercial enterprises and the price merchants pay or receive for their product. Merchants must be able to make a decision on how not only to price these risks in a commercial transaction, but also how to manage these risks. The ability to manage these risks not only benefits the merchants, but also the supplier and ultimate consumer of the finished good.

² September 24, 2013 - <http://www.commoditymks.org/wp-content/uploads/2014/05/CMC-Final-Anticipatory-Hedge-9.24.13.pdf>; February 10, 2014 - <http://www.commoditymks.org/wp-content/uploads/2014/05/CMC-Position-Limits-Comment-Letter-2-10-2014.pdf>; July 25, 2014 - <http://www.commoditymks.org/wp-content/uploads/2014/07/CMC-PL-Roundtable-Comment-Letter-FINAL.pdf>; January 22, 2015 - <http://www.commoditymks.org/wp-content/uploads/2015/02/CMC-Position-Limits-Comment-Letter-1.22.15-AS-FILED-.pdf>

In negotiating a forward contract with a potential counterparty, the merchant must take into consideration all of the above risks to make the most appropriate decision regarding if, when, and how to utilize exchange traded futures to hedge multiple risks that are present – as each risk ultimately affects price. This means both the price to the seller of the raw commodity and the price to the consumer of the final product. The Commission is taking a narrow view of risk, focusing solely on the absolute price risk of a transaction with a counterparty, and is not considering the multiple risks that exist in a commercial operation or enterprise. The logical result of such an approach is that bid offer spreads and credit risk spreads will widen and liquidity will be reduced. This will lead to wider risk premiums throughout the business channel, which will ultimately be passed along to end consumers who will bear the costs.

B. Economically appropriate test

The language of the “economically appropriate” test has been in the law and regulations for a long time, but the proposal’s new interpretation is different. The proposal suggests that to qualify for the economically appropriate test, an entity has to consider all of its exposures when doing a risk reducing transaction and the entity itself cannot take into account exposures on a legal entity, division, trading desk, or even on an asset basis. Rather, all exposure has to be consolidated and then analyzed as to whether or not the transaction reduces the risk to the entire enterprise. This new interpretation substitutes a governmentally imposed one-size-fits-all risk management paradigm for a company doing its own prudent risk management business in light of its own facts and circumstances. Such an interpretation would require commercial entities to build a system to manage risk this way – a system that does not exist today because it does not provide risk management value.

C. Enumerated hedges

The proposal changes current CFTC rule 1.3(z), which states that enumerated hedges or *bona fide* hedges include, but “are not limited to,” a list of enumerated hedging transactions. The proposal lists permitted enumerated hedging transactions and provides little flexibility to market participants. Having a finite list is difficult for market participants who must manage risk because no one can be expected to understand or anticipate every type of hedge that can be done or that fits all markets or market participants. Also, the enumerated hedges that are listed in the proposed rule discount the importance of merchandising and anticipatory hedging. The concept of enumerated hedging transactions focuses much more on the absolute fixed price risk with a counterparty, and inappropriately so. The majority of energy and agricultural merchandising transactions, and associated risk management are generally done on a relative (*i.e.* not fixed) price basis. The examples set forth below illustrate this principle.

D. Merchandising

Merchandising should not be pinned into a specific hedge category as it is a broad concept and connects the two ends of the value chain, production and consumption. One example provided at the February 26, 2015 roundtable that is illustrative of this concept is as follows:

Take for example a commodity (*i.e.* gas oil / diesel) that is being priced at a level in New York ("NY") that demonstrates to the merchandiser that the commodity is in greater demand in that area than in another area (*i.e.* Europe). The underlying is traded on ICE Europe as a gas oil contract and in NY Harbor as a CME ULSD (Ultra Low Sulfur Diesel) contract.

For purposes of example, on January 19th, gas oil was trading at about \$1.51 in Europe and diesel was trading at \$1.66 in NY Harbor. On January 19th, a NY importer would buy physical gas for forward delivery on a floating price basis against the ICE futures. The importer has not yet located a buyer for the product in NY, but intends to ship the gasoline to NY and sell it on a floating price basis and capture that price differential. The importer locks in the ULSD gas oil differential of 15 cents by buying the ICE Feb gas oil futures at \$1.51 and selling to NYMEX at \$1.66. The short NY ULSD futures would not qualify for *bona fide* hedging treatment under the proposed rule, even though it is an essential component of the transaction that allows the importer to take the gas oil from Europe where it is in relatively excess supply and bring it to NY where the prices in the market are dictating that it ought to be sold and delivered.

On January 26th the importer finds a buyer in NY harbor and sells it on a floating price basis. At that point, he has a floating price buy and a floating price sale, and the rules would permit it as a *bona fide* hedge. But for that interim period (a week in this example), it is not a *bona fide* hedge. On January 29th, both counterparties to the importer agreed to price the commodity, and take the indexes that they agreed to use for pricing, and they look at the prices and establish them as the prices for their physical transactions – in this case, the importer could buy actual physical gas oil at \$1.5268, sell physical in NY at \$1.6184 and have revenue from that transaction of 9 cents a gallon. At the same time, the importer would liquidate the futures spread and (in this case) recognize again on the futures transactions 6 cents a gallon. The revenue of the two together is about 15 cents, and when you take out the costs that he anticipated (about 14.5 cents), it yields the expected gain of about three quarters of a cent per gallon – exactly what he hoped to accomplish by hedging and moving the product where it was needed. So even though the price of ULSD dropped by about 40% relative to the price of gas oil in Europe, and dropped by 5 cents in absolute terms, through the use of this hedge the importer was able to preserve the economics of his transaction and move the cargo.

The one week transaction (where he had an unfixed purchase in Europe and had not yet established his unfixed price sale in NY) should qualify as a *bona fide* hedge because it

meets all of the statutory requirements. Namely, the transaction: 1) was a substitute for a transaction to be made at a later time in a physical marketing channel, *i.e.* the sale of physical product in NY harbor; 2) was economically appropriate to the reduction of his risk in that the relative value of the product in NY Harbor could drop before he sold the product on a floating price basis; 3) arose from the potential change in value of an asset (gas oil) that the importer owned after he made the purchase in Europe; and 4) the consumer benefits from this transaction because gas oil was imported to the US in response to market signals, ultimately reducing the cost of fuel in the US. The importer would not have entered into this transaction without the ability to hedge his risk.

Another illustrative example provided at the February 26, 2015 roundtable involving winter storage of natural gas:

A natural gas supplier in April 2013, leases storage in order to store and provide gas during the 2015-2016 winter season. Assume the supplier leased storage and his expected cost for storage is 38 cents per MMBTU, but in June 2013, market conditions are such that he is able to lock in a profit associated with that storage by using the futures markets. The supplier can buy October 2015, gas on the market for \$4.299 per MMBTU and can sell gas, which would come out of storage in January 2016, for \$4.69 per MMBTU. The supplier enters into that transaction in the futures markets by buying October natural gas futures and selling January natural gas futures, and locks in that differential. Neither the October nor the January futures contracts would qualify for *bona fide* hedge treatment under the proposed rule. But in September 2015, when the natural gas physical market is active, the supplier is going to buy the gas that he will use to fill his storage in October 2015. When this occurs, the supplier will liquidate his October natural gas futures contract. In December 2015, when the supplier needs to supply his customers (*i.e.* local utilities), he will sell the gas to be withdrawn from storage and liquidate the January natural gas futures contracts.

This storage transaction should be given *bona fide* hedging treatment because it satisfies the statutory standards established by Congress – it was a substitute for transactions to be made at a later time in a physical marketing channel, *i.e.* the purchase of natural gas to fill storage and a sale to withdraw from storage – which was economically appropriate to the reduction of the supplier's risk that he will be able to recover the cost of its storage obligation and separately that he can profit from his business of supplying gas in the winter. This arose from the potential change in the value of an asset (natural gas storage) that the supplier owned and the gas itself that he anticipated owning. Consumers benefit from this transaction because it assures that gas will be in storage during the winter heating season in 2015-2016. The supplier would not have entered into the transaction to commit to storage without the ability to hedge its risk. The supplier wants to hedge the value of his storage not yet leased. If the prices move against him, he will not lease that storage but the futures markets allow him to lock in the value of his asset by hedging in the futures markets.

CMC members are very concerned by the Commission's view of unfixed price commitments. The Commission has failed to recognize hedging needs of unfixed price contracts (*i.e.* basis contracts) as *bona fide* hedging. The business of merchandising is conducted substantially in the form of basis contracts and merchants must be allowed to utilize hedging strategies, including calendar spread hedging to manage this risk. One of the main reasons for hedging is to turn flat price risk into relative risk, and by taking flat price risk and offsetting it with a futures position, a commercial firm creates exactly unfixed or basis positions, the same positions the Commission does not want to recognize as a *bona fide* hedge. Although basis risk is generally less volatile than flat price risk, it is not always the case – basis and unfixed positions still maintain risk and must be allowed to be hedged, managed and recognized.

Recognizing unfixed price transactions in the marketplace is essential to protect market participants, banks, consumer and producers. Unfixed price contracts exist for several reasons, one to minimize the transaction risk from the time that the original transaction is made until closer in time to the ultimate delivery. Unfixed price contracts provide for much greater security with regard to counterparty, credit and default risk by allowing the parties to remain unfixed until closer in time to the period of the final execution of the contract, thereby minimizing the effect of potential price variance that could take place. If the hedging of these contracts were not allowed to be recognized as *bona fide* hedges, the Commission would force commercial enterprises to move toward a fixed price regime with offsetting hedges in the commodity futures market at great expense to suppliers, merchandisers and consumers.

CMC's concern with the Commission's view of unfixed price contracts is not limited to energy markets. Agriculture markets will also be adversely affected by the inability to hedge unfixed price contracts. Below is an example of an unfixed price commitment by a merchandiser of soybeans in the international grain market:

On January 23, 2015, Merchant enters into a contract to sell 4 cargoes (vessels) of soybeans to a counterparty in Asia ("Customer"). The total number of bushels of soybeans sold to Customer is 8 million, or the equivalent of 1,600 futures contracts. Terms of the contract are as follows:

FOB Vessel – New Orleans, Louisiana (*i.e.* shipper is responsible for delivering the soybeans to the port of New Orleans and loading the soybeans on the boat).

First half May 2015 delivery

Price: 75 cents over the May 2015 CBOT Soybean futures contract

Customer has the option to fix the price by transferring May 2015 futures to Merchant via an "Exchange for Physical", or EFP, prior to May 1, 2015.

Merchant will need to purchase 4 cargoes of soybeans and transport them to the export elevator in New Orleans, Louisiana in time to load 4 vessels in the first half of May 2015. Merchant must decide how best to procure the soybeans for the sale to Customer. The

May 2015 futures contract will not provide supply protection for Merchant's commitment to Customer because the CBOT futures delivery for May 2015 soybeans is not in time to satisfy Merchant's contractual commitment. Merchant therefore needs time protection to cover its sale and decides that the March 2015 futures contract is the best solution. On the date of the sale to Customer, the CBOT futures price for March 2015 soybeans was \$9.72 per bushel and the CBOT futures price of May 2015 soybeans was \$9.79 per bushel. Thus, the March 2015 contract was priced 7 cents per bushel below the May 2015 contract. Since Merchant's best supply protection is the March 2015 futures contract and the commitment to Customer is indexed to the May 2015 futures contract, Merchant is exposed to calendar spread risk. If the March futures contract were to narrow or go above the May futures contract, the transaction with Customer could incur large losses. Merchant decides to protect its commitment to Customer and lock in the discounted price of the March futures contract compared to the May futures contract by purchasing 1,600 March 2015 futures and selling 1,600 May 2015 futures.

Merchant will eventually receive 1,600 long May 2015 futures from Customer via an EFP whenever Customer decides to fix its purchase contract prior to May 1, 2015. Merchant's short May 2015 futures position will be offset by the long futures received from Customer.

Merchant begins purchasing soybeans in the most economically appropriate manner. Merchant procures from various sources in the physical market. As Merchant purchases soybeans on fixed price basis and as unfixed price sellers fix their sales, Merchant sells March 2015 futures to offset its long March 2015 futures.

As Merchant approaches March 2015 futures delivery, the physical market for soybeans begins to trade at price levels in excess of the CBOT delivery value for March 2015. Merchant takes delivery of 1,000 contracts through the March 2015 CBOT delivery process and uses the soybeans to supplement other soybeans purchased in the physical market in order to fulfill its sales commitment to Customer.

On April 23, Customer transfers 1,600 long May futures contracts to Merchant via an EFP, resulting in liquidation of the Merchant's short May position. The contract pricing between Merchant and Customer is now fixed prior to the time specified in the contract between the parties.

The above transaction is an example of what has been the standard of international grain merchandising for many years. However, under the proposed rule, Merchant would not be allowed to enter into the calendar spread transaction to hedge its risk, thus it would not be able to hedge its contractual physical supply commitment to Customer. This could result in a less efficient export transaction (i.e., higher prices quoted to the importer and lower prices quoted to the domestic sellers) and impede convergence of futures and physical markets. The Commission's reasoning for denying *bona fide* hedging treatment is based on the sole fact that the sales contract to Customer was not a fixed price commitment at the time of the hedge by the Merchant. The consequences of the Commission's narrow

interpretation of *bona fide* hedging will force Merchant to change the manner in which it merchandises to end users. Merchant, in order to protect its ability to utilize futures as a hedge against physical supply commitments, may be forced to contractually require Customer to fix its May 2015 soybean contract by “first notice day” of the March 2015 soybean futures contract. Thus, in effect, the unintended consequence of this rule change may be that the Commission is mandating the date by which the end user prices its soybeans.

Similar to the energy examples listed above, the agricultural merchandising example should be given *bona fide* hedging treatment because it satisfies the statutory standards established by Congress (it was a substitute for transactions to be made at a later time in a physical marketing channel and was economically appropriate to the reduction of risks in the commercial enterprise as the hedge protected the potential change in value of soybeans being merchandised).

Comments Related to the Revised Table 11a Position Limits

In previous comment letters, CMC, along with its members, has advised the CFTC that at whatever level single month and all months combined limits are set, parity should be maintained among the three primary U.S. wheat contracts – CBOT Wheat, KCBT Hard Winter Wheat, and MGEX Hard Red Spring Wheat. Under the Proposed Rule, each of the three contracts will be subject to different single month and all months combined limits, doing away with the parity approach that has worked for decades.

Revised Table 11a illustrates the destructive effects that the elimination of wheat parity will have in the marketplace. A comparison of Table 11 and Revised Table 11a reveals that while the unique persons holding positions in KCBT Hard Winter Wheat and CBOT Wheat remain relatively constant, the unique persons holding positions in MGEX Hard Red Spring Wheat skyrocket in every identified category, to a factor far in excess of the other two contracts.

The disproportionate impact of the Proposed Rule impedes legitimate risk management strategies across the three wheat contracts, such as cross-hedging and spread trading. It forces a hedger seeking to spread CBOT Wheat and MGEX Hard Red Spring Wheat to either (1) limit their spread trading to the lowest threshold; (2) apply for *bona fide* hedge exemptions in certain contracts, or; (3) cease using the futures markets for risk management. None of these options are desirable.

Wheat parity has proved effective for decades, and the CFTC has not put forth any evidence that would warrant a move away from wheat parity in the Proposed Rule. Given the adverse implications of the divergent single month and all months combined limits for the three major U.S. wheat contracts, CMC urges the CFTC to maintain the historical success of wheat parity at whatever quantitative limit is established.

III. Conclusion

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

Sincerely,



Kevin K. Batteh
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Commodity Markets Council