March 30, 2015

Mr. Christopher Kirkpatrick
Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581

Re: Position Limits for Derivatives and Aggregation of Positions (CFTC RIN 3038-AD99, 3038-AD82)

Dear Mr. Kirkpatrick:

Better Markets, Inc.[1] appreciates the opportunity to comment once again on the above-captioned Proposed Rule (the "Proposed Rule") published by the Commodity Futures Trading Commission ("CFTC", "Commission") on December 12th 2013, the purpose of which is to establish position limits for certain physical commodity derivatives, as required by and pursuant to provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("the Dodd-Frank Act").[2] On February 25, 2015 the Commission requested additional comments regarding certain issues raised at the Commission's Energy and Environmental Markets Advisory Committee meeting on February 26, 2015. Below we provide an overview of our comments regarding the Position Limits and Aggregation proposals, including comments addressing the specific issues in this request for comment.

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1 Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

2 While this letter responds specifically to the Proposed Rule, it builds upon the information contained in the following comment letters filed by Better Markets, which are incorporated hereby as if fully set forth herein. *See* Better Markets Comment Letter, "Position Limits for Derivatives," (Mar. 28, 2011), *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=34010 ("March 28, 2011 Letter"); Better Markets Comment Letter, "Position Limits for Futures and Swaps," (Jan. 17, 2012), *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=50076 ("Jan. 17, 2012 Letter"); Better Markets Comment Letter, "Aggregation, Position Limits for Futures and Swaps," (Jun. 29, 2012), *available at* *http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=58292* ("Jun. 29, 2012 Letter"); Better Markets Comment Letter, "Aggregation of Positions" (Feb. 10, 2014), *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=59715 ("Feb, 10, 2014 Aggregation Letter"); *and* Better Markets Comment Letter, "Position Limits for Derivatives," (Feb. 10, 2014), *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=59716 ("Feb 20, 2014 Position Limits Letter").

INTRODUCTION

For nearly 100 years, commodity markets have operated under the Congressional mandate to prevent excessive speculation, and the public debate over the role of speculation in commodity markets, and the role of regulators in containing it, has existed even longer.[3] While the scope and degree of enforcement has varied significantly over the years, regulators have repeatedly seen fit to limit speculative positions in response to nearly every market crisis since the 1920's. Now, in the midst of one of the largest sustained disruptions to commodity markets in their volatile history, speculative position limits have never been more essential.

The Proposed Rule indicates the Commission's acknowledgement of the urgent call to action, but falls short of accomplishing its intended goal of restoring and protecting the utility of these markets to physical commodity producers and consumers.

While this comment will cover the substantive issues identified above, we remind the Commission that exhaustive treatment of these and other related topics is contained in previous comment letters submitted by Better Markets. In addition, various other public interest groups, academics, and commodity producers and end-users have provided much thoughtful input on an array of issues arising from and related to the Proposed Rule[4].

Ultimately we conclude that the Proposed Rule has crafted Position Limits that are so high, and so narrowly applied, that they would fail to meaningfully prevent or reduce excessive speculation outside of the most egregious cases of manipulation. They would also fail to capture particularly harmful types of speculation such as Commodity Index Trading, despite the fact that Congress clearly empowered the Commission to place additional limits on any "group or class of traders." Importantly, lower limits and specific limits for Commodity Index Traders ("CITs") are necessary to prevent excessive speculation.

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[3] On the discourse leading up to the 1936 CEA: "Like the debates throughout the 1920s, opinions sharply differed as to whether regulation could better be accomplished by the exchanges rather than by a federal agency,22 whether speculators were to blame for depressing grain prices, and whether the imposition of limits on speculation would impair the ability of grain merchants and others in the grain business to hedge." *See Testimony of Dan M.* Berkovitz "Position Limits and the Hedge Exemption, Brief Legislative History" (Jul. 28, 2009), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/berkovitzstatement072809#P19_5690.

[4] *See* ATA Comment Letter (Apr.23, 2010), *available at* *http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=17197&SearchText*;
Delta Airlines Comment Letter (Mar. 28, 2011), *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=33989;
Americans for Financial Reform Comment Letter (Mar. 28, 2011), *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=34046;
University of Maryland School of Law Comment Letter (Mar. 28, 2011), *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=33850;
Commodity Markets Oversight Coalition Comment Letter (Aug. 31, 2011), *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=48123.

Unfortunately, after all this time and all this work, the core functions of the commodity markets will not be adequately served by this rule as currently drafted.

COMMENTS

1. **Putting Modern Commodity Markets into Context**

Physical commodity markets, by their nature, are the exclusive domain of producers and consumers of tangible products. They are unique markets in this capacity, as the primary participants are almost exclusively one-way actors: producers sell their product, and consumers buy it. In practice, there is scant reason for either participant to transact on the other side of the physical market. This presents an obvious limitation on the ability of producers and consumers to optimally transact within the physical market – the demand of consumers and the supply of producers need not, and often do not, coincide to efficiently transact.

The commercial benefit of derivatives markets stems from the balance of its ecosystem: producers, consumers, and two-way traditional speculators, all in appropriate proportions. Thus the service of speculators is important to the smooth function of the commercial market. **Speculation provides a liquidity buffer supplied by a minority of two-way market participants with goals uncorrelated to those of commercial hedgers.** However, allowing outsiders with no commercial stake into this important marketplace **also carries a critical risk, especially when their involvement is allowed to exceed what is necessary to serve the producers and consumers**.

Speculators have a long history of causing enormous disruption and damage to the commodities markets and commodity market participants when they have amassed sufficient:

- *market proportion* (when speculation as a whole is too great a percentage of the market),
- *market concentration* (when one trader or a small group control too much of the market), or
- *manipulative intent* (when a trader or group seeks deliberately to distort prices for private profit).

To prevent these risks and damage from materializing, speculators must be vigilantly monitored and managed, or the benefits of the liquidity buffer will not outweigh its costs—costs ultimately born by producers, purchasers, businesses, and consumers on Main Streets across the globe when speculative boom and bust cycles are created.

Speculation in Derivatives Markets Pre-2000

Unlike many other global markets, the long history of commodity markets provides ample market data to inform modern regulators as they design an appropriate regulatory regime. Historically, speculators in commodity futures have constituted between 15%-30% of market activity, and within this range speculators productively facilitated effective hedging without meaningfully disrupting or independently shaping the market's behavior.[5]

Intuitively, this makes sense. The beneficial role of speculators is to intermediate between producers and consumers of physical commodities as they hedge. One might imagine a perfectly disjointed market, whereby producers and consumers never match to efficiently transact with each other. In such a market, the optimal level of speculation would approach 50%, since every transaction would require an intermediate trade by a speculator to eventually match all the producers and consumers. In practice, of course, producers and consumers do naturally match up some percentage of the time without the requirement of an intermediating speculator, bringing the required percentage of speculation in a market to somewhere significantly below 50%.

Both common sense and market practice have demonstrated that when speculators (who are not commercially chained to underlying fundamentals) constitute a minority of the market, they contribute to market efficiency[6]. To the extent that hedging (and the fundamental supply and demand that compels it) dominates a market, the market tends to behave in a relatively predictable manner and tends to trade largely based on macro-supply and demand forces.

Conversely, when speculative trading predominates in a market, the majority of trading decisions are based on the expectation of price action derived from the speculative decisions of others. This is fundamentally at odds with the purported goal of the futures market, which is to serve commercial hedgers whose risks reflect not the whims of professional speculators, but the supply and demand of physical products. In some cases, a full-fledged speculative boom can occur, followed by its corollary, a speculative bust. Ultimately this excessive volatility harms commercial end users trying to respond to market signals that are driven by excessive speculation, not supply and demand forces. **The goal of commodity derivatives market regulators should be to facilitate commercial trade in commodities, not to promote or protect commodity gambling**.

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5 *See* e.g. Working (1960), Peck (1981).

6 In response to measures to regulate speculation in Grain Markets after World War I, Herbert Hoover testified before the U.S. Food Administration in 1921, "my own inclination is to believe that as long as those speculative transactions are in comparatively small quantities they neutralize each other; it is only when a preponderant amount is handled by one hand that it can be made the instrument of manipulation." *See Testimony of Dan M.* Berkovitz "Position Limits and the Hedge Exemption, Brief Legislative History" citing Testimony of Herbert Hoover, at pp. 900, 902 (Jul. 28, 2009), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/berkovitzstatement072809#P19_5690.

Speculation in Derivatives Markets Following De-Regulation

Following nearly thirty years of reasonably orderly commodities markets, a decade of deregulation swept through the financial and commodity markets in the 1990's. In the newly relaxed regulatory environment of the early 2000's, the level of speculation in certain commodity markets skyrocketed, effectively reversing the ratio of hedgers to speculators in the market.[7] The point is crucial: the longstanding ratio of commercial to non-commercial market activity effectively reversed within a decade – and in many cases, non-commercial speculative activity came to predominate market open interest for the first time in history. **Commercial interests lost control of their own market.**

As one might expect, a derivative price is unlikely to maintain fidelity to its underlying product when only a third of its market is exposed to the physical supply and demand.[8] Indeed, the newly dominant force in commodity derivative markets has often brought with it a substantial pricing disconnect from underlying physical markets in recent years, harming the ability of producers and purchasers to effectively hedge their risks in the futures market.

A New Class of Players Enters Commodity Derivatives

Much of the increase in non-commercial market-share stems from the emergence of a new group of traders into futures markets. A significant portion of the speculative activity flowing into futures markets in recent years has come not from traditional speculators seeking profit from short-term price action, but instead from Commodity Index Traders ("CITs"), including commodity Exchange Traded Funds ("ETFs"), Commodity Index Funds, and other related instruments. Together, they form a new family of investment vehicles with features that demand particular attention and strict oversight but are currently subject to very little regulation, if any.

The key distinction that makes CITs a unique type of market player is that they are neither commercial nor speculative traders in any traditional sense. As institutional investors, the buyers of commodity index products obviously have no physical commodity risk they are looking to offset, yet they do not share the trading objectives of traditional speculators who enter the market to pursue a view on price movements driven by fundamental supply and demand factors. The objective of CITs is strictly to put assets under management to work by purchasing commodity futures contracts. The purchases are programmatically dictated by net inflows to these funds, and are largely divorced from

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7 Please see Position Limits Letter Feb 10, 2014 for an in-depth illustration of this dramatic increase in speculation.

8 This phenomenon is well established in bond markets as well. For example, naked CDS driving referenced bond yields. *See* Palladini, Giorgia and Portes, Richard, "Sovereign CDS and Bond Pricing Dynamics in the Euro-area," (Nov. 2011), *available at* http://www.nber.org/papers/w17586.

market factors specific to these contracts or their underlying commodities. The process is driven by modern portfolio theory consultants, which prescribe their current ideas on optimal asset allocation. We will discuss the unique qualities of CITs below, and have previously addressed this issue in great detail in the previous comment letters.[9]

Importantly, the current constituency of derivative market participants is now threefold: commercial hedgers, traditional speculators, and programmed index speculators. In modern markets, the threat posed by this new breed of speculators has evolved and regulators must meaningfully address this new threat.

2. The Role of Speculation and Recent Market Structure Changes

The evolution of commodity markets has coincided with a number of broad disruptions to their behavior. The increase in total market volume – driven by an influx of speculation – has tracked both a sharp rise of price volatility, and a convolution of traditional curve shapes of individual commodities. In combination, these factors reflect a futures market that is too often untethered from supply and demand fundamentals. Importantly, this calls into question the benefit that is actually provided by this additional speculative volume. Thus, determining and strictly enforcing the appropriate proportion of speculation is crucial for informing the effective design of speculative position limits by the Commission.

Volume has Exceeded its Ability to Provide Liquidity to Commercial Hedgers

In a balanced market, producers and consumers are aided in their hedging by sufficient speculative interest that seeks to profit from price moves. Speculators, unconstrained by commercial needs, can keep markets in check by coming in to sell when prices appear too high, and buy when they appear too low. Speculators can also be buyers when commodity consumers are insufficient to match the future supply of producers, and speculators can be sellers when producers don't immediately meet the hedging demands of

[9] This letter builds upon the information contained in the following comment letters filed by Better Markets, which are incorporated hereby as if fully set forth herein. *See* Better Markets Comment Letter, "Position Limits for Derivatives," (Mar. 28, 2011), *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=34010 ("March 28, 2011 Letter"); Better Markets Comment Letter, "Position Limits for Futures and Swaps," (Jan. 17, 2012), *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=50076 ("Jan. 17, 2012 Letter"); Better Markets Comment Letter, "Aggregation, Position Limits for Futures and Swaps," (Jun. 29, 2012), *available at http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=58292* ("Jun. 29, 2012 Letter"); Better Markets Comment Letter, "Aggregation of Positions" (Feb. 10, 2014), *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=59715 ("Feb, 10, 2014 Aggregation Letter"); *and* Better Markets Comment Letter, "Position Limits for Derivatives," (Feb. 10, 2014), *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=59716 ("Feb 20, 2014 Position Limits Letter").

consumers. Put another way, when producers and consumers demand liquidity, speculators can provide it.[10] **In the correct proportion, speculators facilitate commerce.**

But there is no evidence that the increased speculative activity in the past 10 years - both outright and as a percentage of open interest - has contributed to more orderly markets, increased hedging ability, improved price discovery, or increased liquidity. In fact, there is evidence that the reverse has occurred.

Every trade transmits information about the trader's views throughout the market. This is fundamental. The information, in aggregate, is the force to which prices move in reaction. Prices do not discriminate based on the class of any individual or any group of traders. As an obvious example, a company's stock price will fall in reaction to large influx of short-selling day traders without regard for the company's strong fundamentals.

As such, a trade by a commercial hedger transmits information about real (or perceived) supply and demand fundamentals throughout the market, and trade by a speculator transmits information about the expectation of short-term speculative price movements. Therefore, the optimal composition of a market is one where hedgers are able to offset *all* of their commercial risk (if they so choose), thereby transmitting the maximum potential information about the fundamental commodity market, with the least amount of intermediation by speculators signaling speculative intent.

Up to a point, every additional speculator may add some marginal liquidity to hedgers, but in doing so simultaneously dilutes the pool of market information to be less reflective of fundamental forces. While bid/offer spreads can only ever approach zero, the dilution of the information pool by speculative trading is unlimited. Therefore, additional volume for which the marginal increase in liquidity is outweighed by the dilutive non-commercial information it transmits is superfluous, and is harmful. **This excess volume is not liquidity at all – it is simply volume.**

The *level of speculation in futures markets has been excessive for many years, and this excess speculation meaningfully affects commodity prices*[11]*.* It has transformed the commodity derivatives market into one where an abundance of speculators trade based on the expectation of price movements caused by other speculators, notwithstanding supply and demand signals and/or the need for hedgers to efficiently offset real commercial risk there. This is a hallmark of overly speculative markets.

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[10] As discussed in a later section of this letter, Commodity Index Funds also consume a large proportion of the short liquidity in the futures markets, but are distinct from commercial hedgers in all other meaningful ways. This distinction lies at the core of the significant risk presented by these funds to the futures market. CITs contain the worst features of all market participants-they are disconnected from underlying supply and demand, yet do not serve to provide liquidity to commercial hedgers-while providing none of the benefits. They are non-commercial liquidity takers.

[11] See Better Markets Position Limits Letter, Feb. 10, 2014.

Of course, this is precisely the rationale underlying the historical need for the imposition of Position Limits: to limit speculation to the level where the liquidity it provides is a net benefit to commerce. The marginal liquidity gains of speculative volume approach zero at some point, and it is up to the regulators to ensure that the level of speculation does not exceed that point.

Decreased Hedging Amongst Commercial Participants

As with any hedge, the value of commodity futures as an effective means to offset commercial price risks relies on their correlation and causality to supply and demand. The changing market structure demonstrates some of the ways that futures markets have ceased to accurately reflect the economic forces underlying the physical markets they represent, which compromises their ability to fulfill their role in allowing commercial hedgers to offset their risk.

Hedging as a percentage of production has been decreasing for years.[12] Accounting for their reduced hedging, commercial hedgers have cited both the decreased correlation between futures and supply and demand, and costly margin requirements on derivatives due to market volatility.[13] Because the margin required for derivatives hedges increases as market volatility rises, the price to hedge against that volatility rises. Since this raises the cost, the value of a given hedge is reduced. Thus, this situation has a meaningful impact on the physical market. Effectively, the cost of doing business is increased, and that increased cost is then passed on to the ultimate customers of these products.[14]

The reduced utility of the derivatives market for hedging demonstrates that the risk of carrying unhedged exposure does not outweigh the cost of offsetting price risk. Fundamentally, the hedge has ceased to be sufficiently valuable, either because its offsetting correlation is insufficient, or the relative cost of carrying the hedge is too great.

The Futures Market Influences the Physical Market

The transmission of dislocation from the derivatives market through to the physical market beneath is a serious threat, and requires comprehensive attention from regulators. It is important to note, however, that while options, swaps, and futures each are linked to the spot market and may exert influence on it indirectly, futures are uniquely and especially

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12 Please see March 28, 2011 Letter for an illustrative graph of production-weighted hedging in wheat markets.

13 *See* Snyder, Brett, "Fuel hedging no guarantee for airlines," CNN.com (Mar. 21, 2011), *available at* http://www.cnn.com/2011/TRAVEL/03/21/airlines.fuel.hedging/.

14 Importantly, the increased cost is felt whether or not the commodity producer decides to hedge his risk or not. Those who choose instead to forego hedging bear the cost of unhedged commercial risk that is ultimately passed on in some other form.

potent in this way. There are several mechanisms by which futures uniquely and directly influence spot prices in ways that swaps and options do not.

First, futures prices serve as a forecast of the spot market. They historically provided a window into the collective expectations of the greater market constituency as to where prices will be in the future, and they are still used as the baseline around which physical auctions are bid and offered. Higher futures prices are taken as an indication that the market expects spot prices to rise, which influences the price the market is willing to pay today.

Additionally, the execution of many commodity products is explicitly linked to the futures price by contractual convention. For example, forward purchases of jet fuel are settled at the prevailing cash price upon delivery. As there is no exchange market for jet fuel, however, the prevailing cash price is contractually determined by a published index (which prices jet fuel by reference the next-to-expire NYMEX heating oil contract). [15]

Finally, and most importantly, futures prices serve as price benchmarks by which all sorts of grades of physical commodities are traded against (less or plus some basis spread). Just like heating oil serves as a benchmark for various grades of jet fuel, WTI and Brent crude oil contracts serve as benchmarks for oil grades around the world (with various sulphurs and other physical characteristics). The CBOT grain contracts serve a similar function for various types of wheat in global markets. Since commercial traders tie physical transactions to benchmark futures contracts, when the prices change in the futures market, it is immediately transmitted to physical prices via commercial hedging contract specifications.

Unfortunately, this common contractual mechanism does not account for the possibility that futures prices are unrepresentative of fundamental factors. If, for example, the price of heating oil futures were subject to undue influence by excessive speculative force, the disruption would be felt directly by airlines purchasing jet fuel for their fleet, given the ties by commercials to the benchmark contract, as explained above.

Commodity derivatives markets, whether physically or cash-settled, in both the spot and non-spot month, have important effects on the prices of actual goods exchanged by commodity producers and consumers. The Commission must appropriately and comprehensively monitor the participants in these markets to ensure that non-commercial participants don't excessively use derivatives, and particularly futures, to damage the utility of commodity markets for those who need them.

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[15] *See* "Platts Oil Pricing and Market-on-Close Methodology Explained," (Jun. 2010*), available at* http://www.platts.com/IM.Platts.Content/InsightAnalysis/IndustrySolutionPapers/moc.pdf.

3. Commodity Index Traders

History and Overview

In aggregate, Commodity Index Traders now comprise the single largest group of non-commercial participants in commodities futures markets, at times even outweighing both *bona fide* hedgers and traditional speculators in market share. To appreciate the scope of the impact CITs may wield on the underlying futures markets, it is crucial to consider some of their unique qualities.

CITs are Long-only and Long-term

Large pools of institutional capital are put to work by buying short-dated commodity futures contracts, which are perpetually rolled forward to maintain duration and avoid expiration. Therefore, the fund exposure is always long across all constituent contracts. The amount of futures contracts purchased is determined exclusively by the amount of investor capital in the fund; sales of futures contracts are only made to reflect outflows from the fund. Further, as one might expect in a product serving as a hedge against inflation, much of the institutional cash is allocated to these funds as a long-term investment. The market implications of these factors are substantial.

In practice, these funds are interpreted by the futures market as a massive amount of demand locked away for an indefinite period of time.[16] Although this does not reflect real interest in physical purchases, the demand for futures meaningfully impacts the real underlying supply and demand curves. **While there must always be a willing seller for these funds to transact, the price those sellers are willing to accept increases in the face of increased demand.** Put another way, over time these funds have structurally pushed up the price of futures, and consequently contributed to the rise in physical commodity prices.[17]

CITs are Programmatically Liquidated and Reinvested ("rolled") into a Longer-Dated Contract on a Frequent and Regular Basis

The process by which CITs provide investors with hassle-free exposure to a basket of commodities involves regular maintenance trades in the derivatives market. In practice, an investment in a CIT is a share of a total-return swap between the fund manager and a

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[16] Before the Senate Permanent Subcommittee on Investigations, Thomas Coyle, the chairman of the National Grain and Feed Association, echoed this point. "These positions held by commodity index traders are primarily long only, held for extended periods, and are not responsive to changes in price. We believe this situation, in which a large portion of the open interest is not for sale at any price for extended periods, has drained liquidity out of the contract and contributed to extreme volatility," *available at* http://www.hsgac.senate.gov/download/stmt-coyle-nat-grain-and-feed-assocjuly-21-09-psi-hrg.

[17] For extensive further discussion and references regarding the upward price pressure caused by CITs, see Better Markets prior comment letters.

swap dealer, which exchanges some fixed rate for the net returns on a basket of futures contracts. As the funds provide perpetual exposure to contracts near expiration, the facilitating swap dealer must regularly unwind these contracts before expiration and enter into equivalent longer-dated contracts. Put another way, several times each year the entire portfolio is liquidated and immediately reconstituted with slightly longer-dated contracts.

What this means is that CITs present a regular large offer on the very short-dated contract, offset by a persistent large bid for a longer-dated one. To the term-structure of the futures curve, this position is a classic commodities forward curve "steepener," and has contributed to a persistent steepening of the futures curve across many commodities since CITs have become a significant force in the markets.

As discussed above, the physical market relies heavily on the futures curve to form market expectations and price forward deliveries. The mechanical re-engineering of the futures curve by CITs has interfered with its capacity to indicate future supply and demand of physical commodities. Indeed, as demonstrated by the persistent state of contango, many commodity futures curves now unhelpfully reflect the asset allocation appetite for investment diversification or inflation hedging by non-commercial investors, rather than the forces of supply and demand.

CIT Investment Decisions Are Price-Insensitive, and Disconnected from Supply and Demand

Index funds increase or decrease their purchases based on net inflows to or outflows from the fund, and without regard to a directional view on the price of any given component or the index as a whole.[18] Recall that CITs are effectively a basket of futures contracts that mirrors the size of the fund based on the return promised in the total return swap. When new investment capital flows into the fund, additional futures of an equivalent amount are purchased in the basket portfolio, regardless of price. The hedge basket is not actively managed outside of periodic rebalancing with the index, and the portfolio is *not* designed to respond to market movements.

Other than the necessary periodic programmed roll purchases and sales, purchases are made when money flows in, and sales are made when money flows out; in neither situation do the futures trades depend on price. Thus, CIT trades are independent of both the futures prices and physical supply and demand. By structuring the total return swaps behind these trades, and thereby back-to-backing this investment interest, swap dealers provide the vehicle through which the disruptive qualities of CITs are transmitted to the futures markets, and ultimately to the physical commodity markets.

[18] By extension, this is also the case for the trades of the sponsoring swap-dealers in connection with facilitating and offsetting the CITs exposure in the futures market.

CITs Do Not Provide Liquidity

Taken together, these qualities demonstrate that **CITs do not provide liquidity to hedgers, and on the contrary they are net liquidity takers.**

As discussed above, volume above and beyond what is required to facilitate commercial hedging does not benefit market liquidity, and importantly the volume provided by long-only passive index funds does not provide useful or necessary liquidity to the market. To the extent that the needs of short commercial hedgers coincide with the pre-determined buying schedule of CITs, they will incidentally provide offsetting interest. But this does not satisfy any meaningful understanding of useful liquidity provision.

In reality, these so-called index funds compete with long hedgers for available short liquidity in the market, since they interact in futures markets as would a commercial participant with large perpetual demand. CITs are bound by their investment strategies to purchase or roll their position according to a schedule and without consideration for the price of any component contract. CITs enter the market to fulfill an investment need, on a predetermined schedule, at whatever price is available. This is the paradigm example of a liquidity taker.

4. The Proposed Rule

The Commission Must Craft a Rule that Achieves All of Congress' Goals

In amendments to the Commodity Exchange Act resulting from the Dodd Frank Act, the Commission has been specifically mandated to impose speculative position limits to achieve four distinct and separate goals:

(i) to diminish, eliminate, or prevent **excessive speculation**;
(ii) to deter and prevent market manipulation, squeezes, and corners;
(iii) to ensure sufficient market liquidity for bona fide hedgers; and
(iv) to ensure that the price discovery function of the underlying market is not disrupted.[19]

It is clear from these explicit criteria that Congress sees four distinct threats to commodity markets, and that *each* is to be addressed in the comprehensive imposition of position limits by the CFTC. Judged by these criteria, the Position Limits Rule, as proposed, is largely a failure. Specifically, the Commission has described, set, and justified position limits that **exclusively** aim to prevent extraordinary instances of market manipulation[20],

[19] CEA section 4a(a)(3); 7 U.S.C. 6a(a)(3).
[20] As discussed below, it is questionable whether the Proposed Rule, as written, even adequately addresses this single criterion. For example, the Proposed Rule would not prevent or deter the market manipulation

while failing to address non-manipulative excessive speculation, insufficient liquidity, or impaired price discovery.[21]

The extraordinary disruptions experienced during the Hunt Brothers manipulation of the silver market or Amaranth's more recent cornering of the Natural Gas market (the two demonstrative episodes used by the Commission to show the necessity of Position Limits) contained all four elements listed above, but any manipulation on such a huge scale would of course disrupt the orderly function of markets in multiple ways. Indeed, excessive speculation, insufficient liquidity, and impaired price discovery function are often necessary but not sufficient qualities of market manipulation.

Manipulation in all cases is explicitly prohibited in the Commodity Exchange Act, and Dodd-Frank expanded the Commission's authority to prohibit other disruptive trading practices.[22] These prohibitions do not depend on the class or affiliation of the market participant; they apply to both commercial and non-commercial traders, speculators and commercial hedgers alike.

Position limits were *not* intended to be the Commission's means of preventing market manipulation. They were crafted to be the means of reducing the burden on interstate commerce that specifically arises from excessive speculative activity. While speculative activity (excessive or not) conducted with an aim to manipulate prices would undoubtedly put a burden on commerce, it is only one example of such activity. The burden caused by cumulative effect of smaller speculators acting in tandem may be just as significant—and potentially much greater than—that of a single actor with manipulative intent.

Congress clearly intended position limits to be designed to limit a variety of harmful activities, including outright manipulation *as well as those instances of excessive speculation that may not be intentionally manipulative.* In the preamble to the Proposed Rule, the Commission acknowledges this point, yet fails to include any examples of such activity in their necessity finding, and fails to propose position limits that could reasonably be expected to address such activity.

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conducted in the 2011 Parnon Energy case, where the firm used the physical market to manipulate the settlement price of their futures position. http://www.cftc.gov/PressRoom/PressReleases/pr6041-11

[21] This point was illuminated in the Preamble of the Proposed Rule, when referencing the views of a former Commission Chair. "Former Commission Chair Philip McBride Johnson told Congress that position limits were "predicated on several different sections of the Commodity Exchange Act which pertain to orderly markets and the terms 'manipulation, corners or squeezes' refer to only one class of market disruption which the limits established under this rule are intended to diminish or prevent**."** FR 75693

[22] Manipulation: CEA section 9, Disruptive Trading Practices: Dodd-Frank Act § 747 *See also* Better Markets Comment Letter, "Antidisruptive Practices Authority,"(Jan. 3, 2011 available at http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=42710&SearchText=better%20markets.

Position Limits that effectively limit the threat of excessive speculation must be set at a level significantly lower than that which would limit market manipulation alone. The limits must account for the cumulative effect of identical speculative positions that may not be excessive on an individual basis but constitute excessive speculation in the aggregate[23].

Commodity Index Funds Must Be Subject to Strict Speculative Position Limits

The Commission is empowered with explicit statutory authority to impose position limits on CITs. The CEA was modified to *strengthen* aggregation requirements by applying them to contracts in the same underlying commodity and to economically related contracts, across all venues. Additionally, in connection with the position limits set out in Section 737 of the Dodd-Frank Act, Congress included the following provision:

> "[S]uch limits upon positions and trading shall apply to positions held by, and trading done by, two or more persons acting pursuant to an expressed or implied agreement or understanding, the same as if the positions were held by, or the trading were done by, a single person."[24]

It is clear that the large universe of CITs, which trade en masse with respect to an explicit programmed common buy/sell strategy, satisfy this provision.

There is no possible justification, nor has the Commission provided a justification, for exempting CITs from the proposed Position Limits. In the preamble to the vacated Position Limits rule, "Vacated Part 151," the Commission explains that it lacks sufficient experience in applying limits to a "group or class of traders" and therefore would not be setting such limits in the rule.[25] **Congress did not permit the discretion of the Commission to apply limits to those areas where they have sufficient experience.** This is an unacceptable abdication of responsibility and a violation of the statutory mandate given to the Commission.

Further, it is overwhelmingly clear that the application of position limits to CITs and the swaps and futures offsetting the risks of these traders would indeed satisfy all remaining statutory criteria as mandated by Congress. Comprehensive application of Position Limits to

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[23] See Better Markets' comment letter regarding Aggregation of Positions, submitted February 10th, 2014, for an in-depth treatment of this issue.

[24] 7 U.S.C. § 6a(a)(1).

[25] Vacated Part 151 Final Rule, 11/18/11 – FR71657: Historically, the Commission has applied position limits to individual traders rather than a group or class of traders, and does not have a similar level of experience with respect to group or class limits as it has with position limits for individual traders. Therefore, the Commission believes more analysis is required before the Commission would impose a separate position limit regime, or establish an exemption, for a group or class of traders, including CITs. The Commission welcomes further submissions of studies to assist in subsequent rulemakings on the treatment of various groups or classes of speculative traders.

CITs alone will meaningfully combat excessive speculation and offer at least a partial remedy for the substantial inadequacies of the Proposed Rule.

Subjecting CITs to Position Limits Would Diminish, Eliminate, or Prevent Excessive Speculation

The existing level of speculation in the commodity markets is excessive – and in recent times has approached crisis levels. Despite more than five years of observation and inaction, the Commission is mandated to use its authority to eliminate or minimize the harmful speculation that has caused vast disruption in commodity markets. The Proposed Rule would set speculative position limits so high and narrowly that they would fail to diminish, eliminate, or prevent any excessive speculation that is not incidental to extraordinary market manipulation.

Despite the incredible fact that very few traders would exceed the limits as currently proposed, CITs would collectively exceed the limits if appropriately aggregated according to the statute.[26] Bringing the *class* of CITs within the scope of speculative Position Limits, even at their current exorbitant level, would produce a meaningful reduction of excessive speculation and thereby satisfy the first statutory objective.

5. Specific Suggestions to Address CIT Concerns in the Proposed Rule

Index Funds Must be Specifically Included in the Definition of Reference Contract

The most straightforward and commonsense way for the Commission to fix the Proposed Rule, to satisfy the Congressional mandate and the spirit of the law, is to include "commodity index contract" in the definition of "reference contract." The existing definition of "referenced contract" in § 150.1 includes "commodity index contracts," and the Commission has provided no justification for its exclusion now.

We urge the Commission to reconsider the ample evidence it has received in studies, comments, testimonies, and reports demonstrating the harmful and disruptive effects of CITs on the futures market. As Better Markets and many others have demonstrated, commodity index products are enormously influential within the futures markets, and must be considered a "reference contract" and brought within the scope of the rule.

The Final Rule Must Aggregate on Contract Class

Speculative limits should apply separately to each contract class. Swaps, futures, and options should be aggregated and subject to Position Limits separately from OTC swaps, as

[26] "…this formula would result in levels for non-spot month position limits that are high in comparison to the size of positions typically held in futures contracts. Few persons held positions over the levels of the proposed position limits in the past two calendar years," FR 75731.

well as on a combined basis. The issue of Aggregation is treated in detail in the Aggregation letter submitted by Better Markets on February 10th 2014.[27]

Position Limits Are Too High To Prevent Excessive Speculation

As has been noted, even in a market where producers and consumers are constantly mismatched, the level of speculation required to provide liquidity would never exceed 50% of the market (the level at which each and every trade between producers and consumers is intermediated by a speculator). In a more realistic market, the optimal level of speculation will be considerably lower, and this is borne out by the fact that traditionally speculation has hovered between 15% and 30% of market share (measured in open interest).

If the Rule is to diminish the excessive speculation that is currently damaging the commodity markets, it must ensure that position limits are set at a level that will restore this historical balance. Without the access to data that the Commission enjoys, it is difficult to pinpoint the precise limits that are necessary to address this problem.[28]

Nevertheless, it is possible to draw some general conclusions about the impact position limits would have if implemented at the levels suggested in the Proposed Rule. The individual month limits and all months combined limits approach 2.5% of open interest. These are effectively the same inflated limits that have been in place for legacy commodity contracts for years, ever since the long-standing previous position limits regime was gradually eroded in the 1990s and 2000s.

Yet within the past few years, numerous violations of even these bloated limits have been documented. Large investment banks like Citi,[29] JP Morgan,[30] foreign banks like ANZ,[31] and UBS,[32] as well as Merrill Lynch Commodities,[33] Futures Commission Merchants like

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27 Available at: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=59715.

28 In similar instances the Commission has at least presented aggregated data and findings for public comment. For instance, in the Swap Entity Definition Rule, data was presented to give commenters a sense of how many entities would be affected by setting the various classification criteria at different levels. A similar analysis in the case of position limits would be of great benefit, and is well within the Commission's capabilities to produce.

29 *See* Alper, Alexandra, Citi to pay penalty for position limits violation: CFTC" (Sep. 21, 2012), *available at* http://www.reuters.com/article/2012/09/21/us-cftc-citigroup-idUSBRE88K16320120921.

30 *See* CFTC Press Release "CFTC Orders JP Morgan Chase Bank, N.A. to Pay $600,000 Civil Monetary Penalty for Violating Cotton Futures Speculative Position Limits" (Sept. 27, 2012), *available at* http://www.cftc.gov/PressRoom/PressReleases/pr6369-12.

31 *See* "ANZ cops US fine for 'excessive speculation'" (Sept. 28, 2012), *available at* http://www.smh.com.au/business/banking-and-finance/anz-cops-us-fine-for-excessive-speculation-20120928-26pdo.html.

32 *See* Weinberger, Evan, "CFTC Fines UBS Over Position Limits On Energy Futures" (Feb. 25, 2010), *available at* http://www.law360.com/articles/151764/cftc-fines-ubs-over-position-limits-on-energy-futures.

33 *See* Warner, Melodie, "CFTC Fines Merrill Lynch Commodities $350,000 For Exceeding Position Limits" (Dec. 7, 2011), *available at* http://online.wsj.com/article/BT-CO-20111207-710223.html.

Newedge,[34] proprietary trading firms like Sheenson Investments,[35] and even individuals like James Masterson[36] have all been fined for violating position limits in commodity markets since the passage of Dodd-Frank required the CFTC to clamp down on excessive speculation. In a single week, over $2 million of fines were assessed for traders exceeding position limits in cotton alone.[37]

What this demonstrates is that there are at any given time a large number of speculators operating close to the position limit threshold. Yet if position limits are set as high as 2.5% of open interest, this means just twelve non-commercial traders would need to be active in a market to take the percentage of speculative activity to the historical 30% level required for optimal functioning. More than twelve speculators could easily drive the level of speculation far above the optimum level.

To avoid this damaging outcome, it is essential that limits be set at a level aimed to maintain no more than 30% speculation in each commodity, and tightened or loosened on a 6-monthly basis depending on the actual level of speculation observed in the market. Basing position limits on an arbitrary percentage of open interest like 2.5% is counter to Congressional intent, and is subject to a perverse feedback loop where increased speculative open interest begets higher limits on speculation. The Commission must therefore take the more direct approach and derive individual limits from the overall proportion of open interest permitted to speculators.

Conditional Spot Limit

There is no justification for treating cash and physically-settled contracts differently in any month, and settlement characteristics should not be a determinant of the ability to exceed the limits in any month. [38] The rationale behind including conditional spot limits, which allow a trader with only cash-settled contracts to hold five times the limit, is yet

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[34] *See* Press Release "CFTC fines Newedge for exceeding position limits" (Feb. 7, 2011), *available at* http://www.futuresmag.com/2011/02/07/cftc-fines-newedge-for-exceeding-position-limits.

[35] *See* "ANZ cops US fine for 'excessive speculation'" (Sept. 28, 2012), *available at* http://www.smh.com.au/business/banking-and-finance/anz-cops-us-fine-for-excessive-speculation-20120928-26pdo.html.

[36] *See* Wilson, Jeff, "CME Fines Speculator $15,000 for Violating Position Limit Rules" (Feb. 4, 2011), *available at* http://www.bloomberg.com/news/2011-02-04/cme-fines-speculator-15-000-for-violating-position-limit-rules.html.

[37] *See* Perez, Marvin, "U.S. Regulators Fines on Cotton Trading Limits Tops $2 Million" (Sept. 28, 2012), *available at* http://www.businessweek.com/news/2012-09-28/u-dot-s-dot-regulators-fines-on-cotton-trading-limits-tops-2-million.

[38] Proposed Rule § 150.3(c) (c) Conditional spot-month limit exemption. The position limits set forth in § 150.2 may be exceeded for cash- settled referenced contracts provided that such positions do not exceed five times the level of the spot-month limit specified by the Commission and the person holding or controlling such positions does not hold or control positions in spot-month physical-delivery referenced contracts.

another instance of the Commission inappropriately crafting rules that target manipulation instead of the broader category of excessive speculation.

First, as demonstrated above, cash-settled contracts can disrupt the price discovery function provided by the futures market. Traders dealing in exclusively cash-settled contracts wield enormous influence on physical prices, both by shaping market expectations of future supply and demand, and directly determining physical transaction prices through contractual convention.

Additionally, the Proposed Rule *does not* prohibit speculators in cash-settled contracts from owning an unlimited position in the cash commodity underlying the contract.[39] Vacated Part 151.4 restricted the cash commodity holdings of a speculator availing the conditional spot limit to 25% of deliverable supply. The Proposed Rule has replaced this common sense restriction in favor of basic reporting requirements for simultaneous cash holding.

This means that a trader may own up to 125% of deliverable supply in cash settled contracts, while simultaneously purchasing up to 100% of deliverable stocks. Not only does this present an obvious opportunity to manipulate prices, the CFTC itself has filed manipulation charges against a firm employing precisely this strategy as recently as 2011.[40]

Conditional Spot Limits consist of a departure from the statutory mandate to deter excessive speculation and unjustly allow outsized position concentration in certain contract-types over others. Conditional Spot Limits must be removed, and all settlement-types should be treated equally in relation to the Position Limits that govern them.

Bona Fide Hedges Should Be linked to Demonstrable Physical Positions

The primary goal of a position limits regime is the restriction of excessive speculative activity by non-commercial interests to protect the utility and, indeed, the viability of the market for genuinely and legitimately commercial interests. Therefore, exemptions must be provided only to those who can demonstrate physical positions, and therefore the specific need to hedge.

To this end, the CFTC has gone to great lengths to carefully consider and enumerate an array of circumstances under which activity in the futures market is a legitimate offset for

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[39] "As proposed, this broad conditional spot month limit exemption for cash- settled contracts would be similar to the conditional spot month limit for cash- settled contracts in proposed § 151.4. However, unlike proposed § 151.4, proposed § 150.3(c) would not require a trader to hold physical commodity inventory of less than or equal to 25 percent of the estimated deliverable supply in order to qualify for the conditional spot month limit exemption." FR 75737

[40] See CFTC Press Release "CFTC Charges Parnon Energy Inc., Arcadia Petroleum Ltd. And Arcadia Energy (Suisse) SA with Price Manipulation in the Crude Oil Market" (May 24, 2011), *available at* http://www.cftc.gov/PressRoom/PressReleases/pr6041-11.

the risks incurred in the physical market. However, the Commission's attempts to address and accommodate the complexity and variety of legitimate hedging strategies present evermore opportunities for evasion.

In particular, any amendment to the bona fide hedge determination process must include an effort to remediate **an enormous flaw in the Proposed Rule**, which effectively allows financial hedges for commodity index funds to avail themselves of bona fide hedge exemptions. The financial risk management activities of swap dealers should not be considered bona fide hedges, and the requirement that such hedges be substantiated by activity in the physical market (***not*** by offsetting positions in swaps) would work to remedy this **troubling loophole**.[41]

Indeed, the fundamental objective of Position Limits is to restrain speculative activity that is unrelated to hedging of physical commodities. Swap dealers, financial derivative offsets, and purely speculative market participants should be universally subject to strict, comprehensive limits.

While there is merit to the concerns of legitimate end-users, who are frustrated with the prospect of retrofitting their activities, it is important to remember that these rules are in place precisely to protect their interests. The overwhelming influence of unbridled excessive speculation hijacked these important markets in 2008, and may do so again without proper oversight.

Limits Must Be Reset More Frequently Than Every Two Years

According to the Proposed Rule, the spot month, non-spot month and all-months-combined position limits will be updated no less frequently than every 2 calendar years. Biennial updates to limits are completely inadequate, and the frequency must be reconsidered.[42] In fact, the clear trend of market measurement across market data providers is higher frequency temporal data. Thus in this case it seems the CFTC is going in the opposite direction.

Moreover, the CFTC is in the midst of a major overhaul of its data regime, and the capacity to record, analyze, and quickly react to market data has never been greater and continues to expand. The vast data collected from Derivatives Clearing Organizations, Swap Data Repositories, and exchanges will for the first time allow the Commission to make

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41 On its own, this kind of hedge determination process would not remedy the inappropriate exclusion of the futures trades that facilitate commodity index funds from position limits. A complete remedy would require additional changes to the proposed Aggregation rule to prevent the netting of swaps and futures positions, as we suggested in the February 10, 2014 Position Limits Letter and February 10, 2014 Aggregation Letter.

42 Section 150.2(e)(3).

adjustments to regulatory measures almost on demand. Intentionally not using new data resources that can enable more timely and market-appropriate limits is unacceptable.

Finally, when the Part 151 Position Limits rules were proposed in 2011, the proposed compliance frequency was yearly. This low frequency was criticized by end user groups and hedgers for being far too infrequent to adequately account for market changes. The Interim Final rule, however, valued the input of swap dealers and their trade groups over that of commercial hedgers and followed the industry recommendation to further reduce the frequency from yearly to every two years.

Unfortunately, as market conditions change, and position limits set earlier become outdated, they can easily become a "safe harbor" for trading activity. Thus, updating position limits more frequently will also have significant benefits to the marketplace. Position limit changes will more accurately reflect current market conditions and more precisely serve the regulatory purposes underlying the position limits rules.

The rules should be designed in such a way that they encourage market participants to monitor their own open interest in order to maintain compliance. Regular updates of position limits will motivate traders to implement stringent monitoring and corrective procedures to adjust their activities to remain in compliance.

CONCLUSION:

We hope that this comment letter aids the CFTC in its effort to address this important rule-making.

Sincerely,

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