

July 13, 2016

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

Re: *Position Limits for Derivatives: Certain Exemptions and Guidance*, RIN  
No. 3038-AD99

Dear Secretary Kirkpatrick:

On June 13, 2016, the Commodity Futures Trading Commission (“CFTC” or “the Commission”) published a “Supplemental Notice of Proposed Rulemaking” (“Supplemental NOPR”) in the Federal Register.<sup>1</sup> The Supplemental NOPR was issued to expand the scope of the bona fide hedge exemptions in the Commission’s proposed position limits rule (“PL NOPR”) issued for comment in 2013.<sup>2</sup> The Supplemental NOPR attempts to improve the PL NOPR by, *inter alia*, establishing a process whereby Designated Contract Markets (“DCMs”) would be delegated the ability to recognize non-enumerated bona fide hedges (“NEBFH”) that commercial firms could utilize in the federal position limits regime proposed in the PL NOPR.

By this letter the Coalition of Physical Energy Companies (“COPE”) provides comments on the Supplemental NOPR and the proposed position limits regime. For physical commercial firms such as COPE members, the federal position limits regime as expanded by the Supplemental NOPR appears to represent the most burdensome regulatory element of the suite of rules proposed or adopted by the Commission to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank”).<sup>3</sup> It is

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<sup>1</sup> *Position Limits for Derivatives: Certain Exemptions and Guidance*, 81 Fed. Reg. 38458 (June 13, 2016).

<sup>2</sup> *Position Limits for Derivatives*, 78 Fed. Reg. 75680 (Dec. 12, 2013).

<sup>3</sup> Public Law No. 111-203, 124 Stat. 1376 (2010).

particularly noteworthy that the proposal will burden those that it is intended to benefit: commercial end-users that rely upon futures and swaps to hedge their commercial risk.<sup>4</sup>

The members of COPE<sup>5</sup> are physical energy companies in the business of producing, processing, and merchandizing energy commodities at retail and wholesale. COPE members generally use swaps, futures, options, and trade options in conjunction with their physical businesses, most typically for hedging. As COPE understands it, as physical commercial companies and hedgers in commodity markets, COPE members are among the intended beneficiaries of the proposed position limits regime. The Commodity Exchange Act (“CEA”)<sup>6</sup> as amended by Dodd-Frank states that the goal of the Commission in setting position limits for derivatives is in part to diminish, eliminate, or prevent excessive speculation, and ensure sufficient market liquidity for bona fide hedgers.<sup>7</sup> While COPE’s members do not perceive a material risk of unaddressed excessive speculation in the contracts they use for hedging, they do see a material risk of inadvertent violations of complex regulations, and anticipate the incurrence of increased

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<sup>4</sup> The Commission has included several requests for comment relating to the burden of the Supplemental NOPR. *See* Supplemental NOPR at 38484 (RFC 33); 38485 (RFC 34). As noted herein and in COPE’s comments to the PL NOPR, the position limits proposal is likely the most burdensome on commercial end-users of all of the CFTC’s Dodd-Frank rules.

The Commission should not assume the rules will be of limited application, but rather should recognize that it is not unusual for a commercial firm to request a hedge exemption from an exchange to ensure that it will have the ability to hedge its risk in dynamic market conditions. Therefore, there will be circumstances where a hedge exemption was requested and granted but market conditions did not arise requiring the firm to exceed the limits. Regardless, it was prudent and proper risk management to obtain the hedge exemption.

As the Commission can see from the foregoing, the scope of firms affected by the Supplemental NOPR and the PL NOPR are all firms that seek hedge exemptions today and any that might do so in the future. That is not a trivial universe of affected entities. The burden on these entities is material.

They will have to: (1) categorize and track each hedging transaction; (2) aggregate and track all cash transactions, production and stores across the affected enterprise; (3) create processes to file required forms; (4) collect data and prepare NEBFH filings; and (5) perform ancillary activities in support of the foregoing. As most commercial firms do not have in place systems and resources to perform these functions, significant new expenditures will likely be required. COPE has not performed a study of the impact of the proposals. However, experience tells us that IT projects always cost more and take longer than budgeted and compliance with complex regulatory requirements does not come cheap. We do not expect the dollar amounts estimated in the Supplemental NOPR and the PL NOPR to come close to what will be required.

<sup>5</sup> The members are: Apache Corporation; Avangrid Renewables, LLC; Kinder Morgan, Inc.; MarkWest Energy Partners, L.P.; Shell Energy North America (US), L.P.; SouthStar Energy Services LLC; and Targa Resources.

<sup>6</sup> *See* 7 U.S.C. 1 *et seq.*

<sup>7</sup> *See id.* at § 6a(a)(3)(B).

expenses in implementing a compliance program arising from the Position Limits NOPR and the Supplemental NOPR.

### **Background**

Since the futurization of swaps in 2012, many commercial end-users have transitioned to a virtually exclusive reliance on futures for hedging.<sup>8</sup> To the degree such hedging requires a quantity of futures in excess of a DCM position limit, the end-user can seek a hedge exemption from the DCM by demonstrating its commercial risk that requires hedging with exchange contracts. The PL NOPR itself does not disturb the DCM position limit process. Instead, it layers on a further set of position limits and related processes for obtaining hedge exemptions. Thus, for end-users that have transitioned to a virtually exclusive reliance on futures (subject to DCM position limits), their singular hedging activity will be simultaneously subject to two very differently-structured regulatory regimes to institute position limits for the same futures contracts. This duplicative structure is self-evidently burdensome and confusing.

In the Supplemental NOPR, the Commission recognized the “experience and expertise of the DCMs in administering their own processes for recognition of bona fide hedging positions.”<sup>9</sup> Based upon the success of the DCM processes, the Commission proposes to delegate to DCMs the authority to recognize NEBFHs for use in the proposed federal enumerated hedge position limits regime.<sup>10</sup> As stated above, the proposal envisions two overlapping position limits but now provides for a mechanism to add NEBFHs (which have been presumably recognized by the DCM in granting a hedge exemption) in the federal position limits process. The Supplemental NOPR also sets forth data and filing requirements for commercial firms to seek and maintain NEBFHs.<sup>11</sup> In addition, it sets forth data, recordkeeping, and process requirements for DCMs.<sup>12</sup>

The Supplemental NOPR is a positive development in that it provides a mechanism for those to hedge commercial risk to meet their legitimate hedging even if they do not fit within the enumerated hedges listed in the PL NOPR. That is a good thing.

However, the Supplemental NOPR is a negative development in that it adds more process and complexity to a proposal that is already overly burdensome and confusing. Layering more process on hedgers – not speculators – to prevent speculation is perverse, and is not a good thing.

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<sup>8</sup> Others with very strong balance sheets or lien-based credit arrangements may not use futures at all relying on swaps to hedge.

<sup>9</sup> Supplemental NOPR at 38466.

<sup>10</sup> *Id.* at 38469, proposed § 150.9.

<sup>11</sup> *Id.* at 38473, proposed § 150.9(a)(6).

<sup>12</sup> *Id.* at 38474, proposed § 150.9(b).

COPE will provide more detailed comments on the Supplemental NOPR but respectfully requests that the Commission, before it gets tangled in regulatory minutia, take a step back and understand what it is seeking to accomplish; who it is proposing to burden; and how it can reach its goal with the least burden and duplication. The Commission has been responsive to the need to limit burdens on end-users.<sup>13</sup> COPE is very appreciative of the Commission's actions in that regard, and believes that the same sensitivity to end-user burden here is essential to a result that will be in the public interest.

### **DCMS Should Be Delegated the Ability to Set Federal Position Limits under Specified Circumstances**

As noted above, the PL NOPR would create duplicative and redundant position limits regulation for commercial firms with a virtually exclusive reliance on futures for their hedging requirements. Since the Commission has recognized the "experience and expertise of the DCMs in administering their own processes for recognition of bona fide hedging positions,"<sup>14</sup> COPE recommends that rather than implement two overlapping position limit regimes for the same purpose and for the same contracts, the Commission delegate to DCMs the ability to set federal limits for such hedgers, in conjunction with the evaluation of hedge exemption requests.

COPE's proposal would work as follows:

- Commercial firms that: (1) use futures for the vast majority of their risk management and (2) have received a hedge exemption from a DCM that in effect sets a new position limit,
  - May utilize the exchange-granted hedge exemption limit as the hedger's effective federal position limit.
    - The ability of a commercial firm to utilize the exchange-granted hedge exemption limit as its federal position limit is dependent upon a futures position that equals or exceeds 80% of its futures equivalent hedging contracts.
      - If the commercial firm's futures position falls below 80% of its futures equivalent contracts, it must notify the CFTC within five (5) business days and become subject to the otherwise applicable federal position limits.

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<sup>13</sup> See, e.g., *Trade Options*, 81 Fed. Reg. 14966 (March 21, 2016).

<sup>14</sup> Supplemental NOPR at 38466.

- The commercial firm must notify the CFTC within five (5) business days of when its position exceeded the otherwise applicable federal position limit.
- The DCM granting the hedge exemption will notify the CFTC of its action simultaneously with its notification to the requesting commercial firm.
  - The CFTC may adjust the federal position limit if it disagrees with the exchange.

Under the above approach, a commercial firm that uses futures for hedging will be subject to a position limit (thereby achieving the regulatory goal of the PL NOPR), but will not be subject to the administrative burden of complying with two overlapping position limit regimes.

For example,

- Company A exclusively uses the NYMEX Henry Hub Natural Gas contract (“NG”) to hedge its commercial natural gas exposure. The exchange position limit is 1,000 contracts. The federal position limit is also 1,000 contracts, each representing 25% of deliverable supply.
- Company A’s *bona fide* hedging requirements are 1,200 contracts.<sup>15</sup>
- DCM grants Company A’s hedge exemption request resulting in an effective exchange limit of 1,200 contracts.
- Company A’s federal limit is also revised to 1,200 contracts.
- The result:
  - Company A is able to hedge its bona fide risk using the tool of the NYMEX Henry Hub contract;
  - Company A is subject to position limits; and
  - Company A does not need to implement duplicative processes to satisfy overlapping regimes that are addressing the identical issue.

COPE submits that the Company A example is not uncommon for commercial hedgers. Many commercial hedgers exclusively use futures for hedging. Those that also use

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<sup>15</sup> Please assume that all such hedging corresponds to the enumerated hedges proposed in the PL NOPR.

swaps<sup>16</sup> do so for a very limited amount of hedging.<sup>17</sup> As the Commission has recognized that its access to part 20 swap data gives it “an indication of a potential position limit violation,”<sup>18</sup> a limited amount of swap activity should not create a regulatory gap.

If the Commission is comfortable delegating NEBFHs to DCMs, it should be equally comfortable delegating the establishment of federal position limits that mirror exchange-granted hedge exemptions predicated on fundamentally the same analysis as the NEBFH – review of bona fide hedging. For commercial firms that have a virtually exclusive reliance on futures for their hedging requirements, there is simply no reason to have two overlapping regimes.

### **Any Delegation Must Permit the DCMs to Exercise Independent Judgement**

The premise upon which the Supplemental NOPR rests is that the DCM has significant experience and expertise in evaluating whether transactions are properly viewed as bona fide hedges.<sup>19</sup> Therefore, the Commission should accord the DCMs a high level of deference in their exercise of the delegation. To COPE’s knowledge, there have been no allegations that DCM hedge exemptions have resulted in “excessive speculation” adversely affecting the public interest. DCM exercise of expert judgement should be respected and CFTC intervention should occur only on rare occasions.

COPE’s view of the Supplemental NOPR is driven by its understanding that a delegation to DCMs based upon DCM expertise and expertise in identifying bona fide hedging will result in the scope of hedging recognized in the hedge exemption process today being carried forward into NEBFHs. If the foregoing is correct, COPE supports the Supplemental NOPR.

However, if the DCM delegation results in an effective reduction in the scope of bona fide hedging recognized by DCMs today, the Supplemental NOPR could easily devolve into a cumbersome and opaque mechanism for CFTC determinations regarding bona fide hedging. As can be seen from the comments filed in the PL NOPR process, there can be considerable debate as to what constitutes a bona fide hedge. In the PL NOPR process, the Commission will make that call after its review of comments from the public.

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<sup>16</sup> The Commission recent announced that it would not subject trade options to position limits. *See Trade Options*, 81 Fed. Reg. at 14971 (March 21, 2016). The elimination of trade options from the scope of position limit affected swaps further reduces the proportion of swaps that commercial hedgers use vs futures.

<sup>17</sup> COPE has proposed an 80% futures threshold as a suggestion of a cut off for its delegation proposal.

<sup>18</sup> Supplemental NOPR at 38461 (internal citation omitted).

<sup>19</sup> Supplemental NOPR at 38466.

Under the Supplemental NOPR, participation in the process of Commission review of a proposed NEBFH appears to be limited to the DCM and the applicant, conducted in a non-transparent manner and without any right of appeal.<sup>20</sup> Since the result of Commission action could be of considerable precedential effect for the industry at large, it is critical that any Commission review be noticed to the public for comment. In addition, there should be a mechanism for appeal of a Commission determination as the rationale for Commission action cannot be known until after a determination is made.

Given the significance of Commission determinations regarding what constitutes bona fide hedges, a full airing of matters on which the Commission overrules a DCM determination must be provided. Such an approach can only work if NEBFH decisions are made by the Commission only in extraordinary circumstances. The credibility of the Supplemental NOPR depends on the ability of DCMs to grant NEBFHs in the normal course.

Further, in the event the Commission reviews a NEBFH determination and affirms that it represents bona fide hedging, such a determination should result in a new enumerated hedge under the Commission's position limits regulations. If the Commission concludes the NEBFH is a bona fide hedge, it should take the next step and make that finding generic to all commercial firms that have similar facts and circumstances.

COPE recommends the Commission adopt a policy statement that: (1) assures that DCMs will be able to exercise their independent judgment consistent with the expertise and experience underlying today's hedge exemption process; and regulatory text that (2) provides transparency and public input in CFTC review of DCM NEBFH determinations; (3) provides an appeal process from such determinations that leaves the DCM determination in effect pending Commission action; and (4) create additional enumerated hedges when Commission review of a NEBFH validates its bona fide status.

A proposed outline addressing COPE's requested policy statement and Commission review process is set forth below:

Policy Statement: In the final rule, the Commission should announce a policy of deferring to DCMs with respect to NEBFH determinations stating that its review of applications will be limited to circumstances which contain significant policy questions.

Commission Review Process: If the Commission undertakes review of an application, either through a request by a DCM or upon Commission action,

- The review is noticed for public comment (with the confidential and proprietary information removed from the underlying facts)

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<sup>20</sup> Supplemental NOPR at 38509 (proposed §150.9(d)(4)).

- A 30 day period for public comment is instituted by Federal Register notice
- Public comment is received by the Commission
  - The Commission will determine whether an additional notice and comment period is required upon the provision of any requested information from the DCM and/or applicant
- The Commission will issue an order approving or disapproving the application including an explanation of its reasoning.
  - If the application is approved, an enumerated hedge reflecting the relevant facts and circumstances of the application will be established.
  - The order may be appealed to the Commission by any affected person w/in 30 days
  - The Commission will act on the appeal within 30 days thereafter
  - The order on appeal may be further appealed to federal court

### **The Supplemental NOPR Should be Revised to Reduce Burdens on Hedgers and DCMs**

The Supplemental NOPR requires every commercial firm seeking a NEBFH to file a unique application with a DCM containing specified information.<sup>21</sup> To maintain the NEBFH, a new application will need to be filed annually.<sup>22</sup> COPE expects that there will be circumstances where multiple commercial firms face similar risks and require NEBFHs for the same purpose.

While the Supplemental NOPR requires that the DCM issue a report of the NEBFHs it has approved, it provides no vehicle for a generic approval of a NEBFH for a commercial firm meeting specified facts. Since, unlike a hedge exemption, the DCM is not granting a firm a specific quantity of bona fide hedging contracts, but rather, is validating the bona fide nature of a hedge transaction, there should be a mechanism for a DCM to announce generic recognition of a NEBFH for hedgers that satisfy certain facts and circumstances. We do not have to invent the wheel over and over.

COPE anticipates that the process envisioned in the Supplemental NOPR for the grant of a NEBFH will be time consuming and resource-intensive. If the result of the process (particularly if DCMs see repetitive requests) is the establishment of a generic NEBFH, the result would be an efficient and transparent identification of transactions that merit

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<sup>21</sup> *Id.* at 38472, proposed § 150.9(a)(3).

<sup>22</sup> *Id.* at 38473, proposed § 150.9(a)(4)(i).



bona fide hedge status. This way, commercial firm filing requirements could be reduced by the firm relying on the generic NEBFH (and so notifying the DCM), and the DCM's need to review applications that already meet previously determined criteria would be reduced.

The Supplemental NOPR should be revised to permit the DCM to generically recognize a NEBFH in cases where multiple commercial firms have sought a NEBFH for a similar risk, based upon similar circumstances.

The Supplemental NOPR also contains several elements that are burdensome to commercial firms seeking NEBFHs. The most problematic are the requirements that a commercial firm: (1) submit three years of history of production or usage; and (2) file periodic reports with the DCM of offsetting cash positions to an approved NEMFH (including updating and maintaining the accuracy of any such report).

There should be no generic requirement of three years of data. Instead, there should be a requirement for a showing of a legitimate business need supporting a bona fide hedge designation. In certain cases, three years of data may be of value; in others it may have no relevance or not even exist. What matters is a credible showing of a real world commercial risk faced by the hedger and a compelling basis to find that a transaction is a bona fide hedge for such risk.

There should be no generic requirements of periodic reports to the DCM specific to the NEBFH. Commercial firms manage risk using futures. That risk management results in a position on the exchange. COPE expects the DCM to be monitoring that position and inquiring if there is any need to better understand a firm's trading. The generic NEBFH reports would seem to be of little value to the exchange and require the hedger to expend unnecessary resources. Further, since in the event a hedger exceeds the federal position limit it will file a Form 204/504 with the CFTC, the Commission could require a copy of that Form 204/504 be sent to the DCM. That way information regarding the firm's cash position and bona fide hedges would be made available to the DCM.

### **The Position Limits Compliance Process is Overly Complex and Burdensome on Commercial Hedgers**

In its comments filed in response to the PL NOPR, COPE addressed the compliance process proposed by the Commission by stating:

The Position Limits NOPR includes a proposal that a suite of forms will be filed by affected persons at various times, with various frequencies, triggered by various circumstances. In general, those not currently subject to federal position limits (such as COPE members) are not required to file any such forms. These forms are not lengthy but they represent a significant data collection and categorization requirement in order for them to be correctly populated. Accordingly, the work required to accurately prepare and file these various forms will not be trivial.

A comprehensive position limits regime could be implemented with a far less burdensome set of filings; (for example, as noted above, Form 504, detailing the composition of the cash positions of each commodity underlying a referenced contract that is held, could be eliminated entirely). COPE requests that the Commission review its proposed forms and ensure that they are as clear, limited, and workable as possible such that burdens can be reduced and the goals sought by the Commission are also met.

Further, COPE requests that the Commission create straightforward, user-friendly guidebooks for the forms it requires to assure that commercial end-user/hedgers as well as the sophisticated CFTC-focused *cognoscenti* can clearly understand and correctly and timely file any required forms. The Commission should also hold workshops to assist in improving the forms and making sure that questions and issues are surfaced and addressed.<sup>23</sup>

COPE reiterates those comments herein as, for the rank and file commercial end-users, they may be the most significant element of the entire position limits effort. Commercial end-users are hedgers. Their transactions will be (and should be recognized as) bona fide hedges. The impact on them will be recordkeeping and form filing. In addition, as noted above, the Supplemental NOPR creates additional burdens on commercial end-users.

The Commission should do everything in its power to make the process it requires of commercial end-users as clear and straightforward as possible.

As an illustration, beyond the general comments above, examples of ambiguities in the proposed forms include:

#### Forms 204 & 504

- What scope of stocks owned, fixed price purchases, and fixed prices sales should be reported?
  - Many commercial firms operate in diverse geographic areas and markets. However, their hedging requirements may be related to a specific market. Are they required to report their enterprise-wide total stocks owned, fixed price purchases, and fixed prices sales even if portions are wholly unrelated to the hedging at issue (or US markets)?
- Do these forms require precise enterprise-wide data that compile all of the affiliated and aggregated entities into consolidated totals?

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<sup>23</sup> COPE Comments Regarding Position Limits for Derivatives, RIN No. 3038-AD99, at 24 (Feb. 10, 2014) (internal citation omitted) (“COPE Feb. 10, 2014 Position Limits Comments”).

- Many commercial firms are members of affiliated groups and/or may be aggregated with non-affiliates under the rules proposed by the CFTC. These firms do not aggregate their physical business activities recordkeeping in their commercial operations. Do affiliated/aggregated firms that otherwise operate independently need to track their physical businesses/activities on a real-time consolidated basis?

As can be from the fundamental questions posed above, there is much that needs to be clarified by the Commission. Further, depending on the guidance provided, there will be much work for commercial end-users in preparing to comply. COPE notes that it is not aware of any software vendors that currently provide solutions that can support a commercial firm's ability to file the proposed forms.

### **COPE Stands By Its Prior Comments**

In its comments to the PL NOPR, COPE made specific requests and provided the general recommendations below:

- The position limits regime enacted should be closely tailored to address the concerns identified by the Commission.
- The Commission should specify all specific referenced contracts covered by position limits.
- Financially-settling swaps and commodity options/trade options should be excluded from position limits (without question trade options should be excluded). Further, the Commission should clarify that hedges of trade options should receive the same *bona fide* hedge recognition as hedges of forward contracts
- The scope of hedges permitted to exceed the limits should track the scope of hedges exempted from the Dodd-Frank clearing requirement through the End User Exception.
- If the enumerated *bona fide* hedge regime is adopted, it should be expanded and liberalized to include the hedging actually used by commercial companies to mitigate their risks.
- The reporting required should be as simple as possible and the Commission should develop a clear rulebook with input from end user /hedgers to create an understanding of what is required in such filings by both the regulator and the regulated.

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- The “five-day rule” should be eliminated and appropriate recognition of cross-commodity hedging should be instituted.<sup>24</sup>

COPE also provided comments on August 4, 2014; March 20, 2015; and November 15, 2015. COPE continues to respectfully request that the Commission fully consider all of those comments and adopt the proposals made therein in any final rule.

### **Conclusion**

COPE respectfully requests that the Commission fully consider these comments together with those it has previously filed. If enacted, position limits is a regulatory requirement that will materially affect commercial end-users such as COPE members. Any federal position limits regime should be carefully constructed to address the asserted policy goal of preventing excessive speculation and do so in a manner that does not create an undue burden on commercial end-users that are hedging risks related to their physical businesses.

Respectfully Submitted,

/s/ David M. Perlman

David M. Perlman

George D. Fatula

**Counsel to**

**Coalition of Physical Energy Companies**

CC: COPE Members

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<sup>24</sup> COPE Feb. 10, 2014 Position Limits Comments.