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

Re: Supplemental Notice of Proposed Rulemaking, Position Limits for Derivatives: Certain Exemptions and Guidance, RIN 3038-AD99

Dear Secretary Kirkpatrick:

API commends the CFTC's efforts in issuing its supplemental notice of proposed rulemaking ("Supplemental Proposal") to address some of the concerns raised by our members in CFTC staff roundtables, Advisory Committee meetings, and comment letters. API particularly applauds the Commission's proposal to rely on the expertise of exchanges to recognize non-enumerated hedge exemptions ("NEBFH"), cross commodity hedge exemptions, and anticipatory hedging exemptions. Nonetheless, API members believe that the proposal does not go far enough to help foster a properly functioning marketplace.

As a general matter, API believes that a final rule on position limits must allow for and preserve currently recognized hedge exemptions. The exchange delegation process must allow exchanges sufficient discretion in a manner that does not result in a punitive penalty to its customers being granted the hedge exemption. A Commission revocation of an exemption approved by an exchange in good faith would only serve to undermine the credibility of the exchange, and as the rule is currently written, does not make clear whether it would expose the exchange to undue regulatory penalties or uncertainty. Once an exemption that has been provided in good faith and an exchange's customer has initiated a multitude of physical market transactions based on the authorization to hedge under this exemption, these contractual obligations in the physical market simply cannot be unwound or undone in a simplistic manner, let alone in a "commercially reasonable amount of time" that could be deemed to be less than one business day.[1] If the Commission decides to obtain a process to revoke a previously granted exchange exemption, API asks the Commission to limit the time period to 180 days to issue a decision to overturn an exemption and provide a meaningful process for market participants to appeal a denial of an exchange granted hedge exemption.

[1] Cite Proposal Footnote 68, which suggest one day

Definition of *Bona Fide* Hedging – Economically Appropriate Risk Management Activities

Any final rule imposing new federal position limits must ensure the adequate breadth and usability of the *bona* fide hedge exemption. In the energy industry in particular, the ability to hedge commercial risks associated with physical commodity transactions is essential. Energy infrastructure development and transactions take place on a large scale and in a complex market, requiring limits that are in step with such scale and that provide for flexible hedge exemptions that can accommodate the unique risks encountered by energy market participants.

The Commission should make certain further modifications to its regulations and guidance with respect to its definition of "*Bona* Fide Hedging Position." Although the Supplemental Proposal mostly addresses the process for obtaining recognition of a *bona fide* hedging position, the preamble to the Supplemental Proposal states that the Commission interprets risk in the economically appropriate test to mean price *risk*, and rejects the adoption for a broader interpretation of risk, including execution, logistics, location, quality, and credit risk.[2] It is essential that the Commission not limit its interpretation of "economically appropriate" to only apply to hedges that address price risk. The price discovery process of the market aggregates participants' collective expectations of innumerable factors impacting supply and demand, and distills that into an expression of price. Commercial firms may seek to hedge risks associated with production, quality, currency, interest rates, counterparty, credit, logistics, and other risks posed throughout their normal course of business. The supplemental proposal imposes a standard that is narrower than, and inconsistent with, the Congressional standard, which requires only that bona fide hedging positions be "economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise." As previously stated, there are numerous risks other than price risk that are economically appropriate to address in the conduct and management of a commercial enterprise. Accordingly, API requests that the Commission clarify its guidance to recognize that "economically appropriate" hedges are not limited solely to hedges that address price risk.

Cross Commodity Hedges

The Commission should revise its guidance regarding its proposed "substantially related" test for cross-commodity hedges to avoid an interpretation that might otherwise exclude cross commodity hedges that satisfy the statutory "economically appropriate" standard. The Commission introduced its "substantially related" test in the Proposed Rule by requiring that fluctuations in the value of any bona fide hedging contract be "substantially related" to the fluctuations in the value of the hedged position. While API agrees that the "substantially related" test can provide helpful guidance as to whether a cross-commodity hedge is economically appropriate for purposes of the bona fide hedging definition, the Commission should at least identify that a NEBFH exemption can be recognized if a hedge position does not satisfy the CFTC's "substantially related" test but is nonetheless "economically appropriate" given the context of the hedge. Specifically in the energy sector, perfect or near-perfect hedges are not generally available, and a cross-commodity hedge should rightfully be considered "economically appropriate."

The Commission's suggested numerical test (80% correlation for a time period of at least 36 months), however, is inappropriate because it fails to take these and other contextual items (such as availability,

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[2] *See Position Limits for Derivatives: Certain Exemptions and Guidance*, 81 Fed. Reg. 38458 at 38463 (June 13, 2016) ("Supplemental Proposal").

or lack thereof, of alternative hedges) into account. For these reasons, the Commission should revise its guidance regarding cross-commodity hedges to recognize that certain derivatives positions in energy and agricultural commodities can satisfy its "substantially related" test for the enumerated bona fide hedging position exemption or at least be "economically appropriate" for purposes of the NEBFH exemption.

Enumerated Hedges – Anticipatory Merchandising Hedges

API requests the Commission to expand the list of enumerated bona fide hedging positions to include all anticipatory hedges – in particular, anticipatory merchandising transactions and cross commodity hedges.

CEA Section 4(a)(c)(2)(A)(iii) expressly defines bona fide hedging transactions and positions as "assets that a person owns, produces, manufactures, processes, or merchandises, or anticipates owning, producing, manufacturing, processing or merchandising." Anticipatory merchandising hedges are crucial to the risk management functions of commercial end-users and are statutorily recognized as bona fide hedges in the CEA. Merchandising activity enables producers to place commodities into the value or supply chains and ultimately brings those commodities to consumers with minimal price volatility. Limiting the ability of commercial firms to utilize these crucial risk management tools could result in increased price volatility, lower prices bid to producers, and increased prices that are passed on to end-users and consumers. In addition, merchandising activity promotes market convergence – which is a crucial aspect of the price discovery function commodity markets serve. A reduction in the efficiency of convergence increases risk, reduces liquidity, and ultimately may lead to both higher consumer prices and lower producer prices. Allowing the full scope of hedging activity promotes more efficient, effective and transparent markets – exactly the public policy goals the Commission wishes to occur. The statutory definition clearly reflects the Congressional intent that anticipatory merchandising transactions should not be subject to federal position limits.

Elimination of the Five-Day Rule

The Commission should eliminate the "five-day rule" from its regulatory definition of "bona fide hedging position," which would otherwise require early liquidation of anticipatory hedges and cross-commodity hedges. Paragraphs 4 and 5 of the definition provide for recognition of such hedges as enumerated bona fide hedges, provided that "no such position is maintained in any physical delivery commodity derivative contract during the lesser of the last five days of trading or the time period for the spot month in such physical-delivery contract" (referred to herein as the "expiry period"). However, such forced liquidation would threaten to leave market participants exposed during the expiry period. By contrast, allowing parties to maintain their hedge positions during the expiry period improves liquidity during such period. Nothing about the proposed rule necessitates implementing an arbitrary restriction on the use of hedge exemptions during expiry. The exchanges already have effective means to deal with potential problems, making the proposed five-day rule a solution looking for a problem.

CFTC Approval of Exchange Recognized Bona Fide Hedge Should be Done in a Timely Manner.

To maintain the practical benefit of the bona fide hedge exemption, it is essential that exemption applications be acted upon in a timely manner. Importantly, the Commission recognizes the importance of upholding "the general principle of timely administration of the application process" in the Supplemental Proposal. In this regard, API agrees that "the individual exchanges themselves are in the

best position to evaluate how quickly each can administer the application process, in order best to accommodate the needs of market participants."

In addition, a Commission revocation of an exemption approved by an exchange in good faith would only serve to undermine the credibility of the exchange, and as the rule is currently written, does not make clear whether it would expose the exchange to undue regulatory penalties or uncertainty. To the customer receiving the exemption, repeal would immediately expose the exemption seeker to additional risk above and beyond the market risks being mitigated via the derivatives transaction. Once an exemption that has been provided in good faith and an exchange's customer has initiated a physical market transaction based upon this exemption, these contractual obligations in the physical market simply cannot be unwound or undone in a simplistic manner, let alone in a "commercially reasonable amount of time" that could be deemed to be less than one business day. A less draconian and more prudent regulatory approach would be for the Commission to limit the time period to issue a decision to overturn an exemption. In addition, the Commission should also look into providing a meaningful process for commercial end-users to appeal a denial of an exchange granted hedge exemption.

Reporting Requirements Associated with Recognition of Bona Fide Hedging Positions Should be Manageable.

The reporting requirements associated with the processes for exchange recognition of bona fide hedging positions must not create compliance burdens or risks that are unmanageable, overly time-consuming, or costly to the point that they deter use of such hedges, which would increase market participant's commercial risk and damage market liquidity.

API supports the Commission's proposed mechanism for reporting enumerated bona fide hedges recognized by exchanges, which would utilize the process established under the Proposed Rule for reporting such positions to the Commission, with an identical copy to be filed with the applicable exchange(s). API believes that a similar process should be used with respect to reporting of non-enumerated bona fide hedges.

In this respect, API members believe that exchange reporting requirements should not require market participants to file reports more frequently than monthly. Daily or even weekly reporting requirements would likely discourage many market participants from making beneficial use of the bona fide hedge exemption.

Respectfully submitted,

Stephen Comstock