



Commodity Markets Council
1300 L St., N.W. Suite 1020
Washington, D.C. 20005
Tel 202-842-0400
Fax 202-789-7223
www.commoditymktcs.org

July 13, 2016

Via Electronic Submission

Chris Kirkpatrick
Secretary
U.S. Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

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

Dear Mr. Kirkpatrick:

The Commodity Markets Council (“CMC”) appreciates the opportunity to submit the following comments to the U.S. Commodity Futures Trading Commission (the “CFTC” or “Commission”) as part of its comment period for its proposed revisions and guidance to the 2013 Proposed Rule concerning federal speculative position limits.¹

I. Introduction

CMC is a trade association that brings together exchanges and their industry counterparts. Its members include commercial end-users which utilize the futures and swaps markets for agriculture, energy, metals, and soft commodities. Its industry member firms also include regular users and members of such designated contract markets (each, a “DCM”) as the Chicago Board of Trade, Chicago Mercantile Exchange (“CME”), ICE Futures U.S. (“ICE”), Minneapolis Grain Exchange, New York Mercantile Exchange, and NASDAQ Futures, Inc. They also include users of swap execution facilities (each, a “SEF”). The businesses of all CMC members depend upon the efficient and competitive functioning of the risk management products traded on DCMs, SEFs, or over-the-counter (“OTC”) markets. As a result, CMC is well positioned to provide a consensus view of commercial end-users on the impact of the Commission’s proposed regulations on derivatives markets. Its comments, however, represent the collective view of CMC’s members, including end-users, intermediaries, and exchanges.

II. The Supplemental Notice of Proposed Rulemaking

CMC commends Chairman Massad for personally acknowledging that none of the current Commissioners were in office when the 2013 Proposed Rule was issued and for his willingness to listen to commercial end-users and other market participants before issuing a final position limits

¹ See *Position Limits for Derivatives*, 78 Fed. Reg. 75680 (Dec. 12, 2013) (“2013 Proposed Rule”).

rulemaking “to understand the significance of these rules to the ability of commercial end-users to continue to use the markets efficiently for risk management and price discovery.”² CMC also commends Commissioner Bowen for personally acknowledging that the current 2013 Proposed Rule is imperfect, and that it can and should be improved to provide more clarity and ease of operation for commercial end-users.³ Likewise, CMC commends Commissioner Giancarlo for his willingness to take “additional steps to ensure that the practical issues raised by the agricultural and end-user communities are addressed in the final rule,” and that the Commission “must balance regulatory burdens with clear economic benefits if we are to maintain liquid commodity hedging markets that support our American way of life.”⁴

CMC appreciates the Commission’s efforts in listening to the concerns raised by our members at CFTC staff roundtables, Advisory Committee meetings, and in comment letters; and responding to some of those concerns through the issuance of the supplemental notice of proposed rulemaking (“Supplemental Proposal”)⁵. CMC particularly applauds the Commission’s proposal to continue to maintain its reliance on the expertise of the exchanges to recognize non-enumerated *bona fide* hedge exemptions (“NEBFH”), spread exemptions, and anticipatory hedge exemptions. Nonetheless, CMC members believe that, on the balance, this proposal does not deliver on current Commissioners’ acknowledgements that the Commission’s position limits rule requires improvement. After a considerable amount of additional CMC and industry input to the current Commission, there are still several key elements that remain either rejected or unaddressed by this Supplemental Proposal that should be reconsidered. The rule remains *imperfect* and more work is needed to allow commercial end-users to *continue* to use the markets efficiently for risk management and price discovery. Additional steps must be taken to provide additional *clarity* and ease of operation for commercial end-users, and to ensure that the practical issues raised by our members are truly addressed in the final position limits rule. We seek rulemaking that affirms time-tested price discovery practices versus a market environment of month-to-month volatility, which may be detrimental to the welfare of consumers both in the U.S and abroad.

CMC members believe that there remain *several key elements* either rejected or unaddressed in the Supplemental Proposal that should be reconsidered prior to implementation of a final position limits rule for the benefit of the American public, farmers, ranchers, merchandisers, and commodities producers. These modest modifications will ensure that commercial end-users continue engaging in effective, essential, sound, and appropriate risk management practices.

² See, e.g., Testimony of Chairman Timothy G. Massad before the U.S. House Committee on Agriculture, (Feb. 10, 2016), <http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-41>; Statement of Chairman Timothy Massad on Supplemental Proposal on Position Limits for Derivatives, (May 26, 2016), <http://www.cftc.gov/PressRoom/SpeechesTestimony/massadstatement052616>; Keynote Remarks of Chairman Timothy Massad before the Global Exchange and Brokerage Conference, New York, NY, (June 9, 2016), <http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-47>.

³ See, e.g., Remarks of Commissioner Bowen before the District of Columbia Bar, (Jan. 12, 2016), <http://www.cftc.gov/PressRoom/SpeechesTestimony/opabowen-7>.

⁴ See, e.g., Statement of Commissioner J. Christopher Giancarlo Regarding Supplemental Proposal on Position Limits for Derivatives: Certain Exemptions and Guidance, (May 26, 2016), <http://www.cftc.gov/PressRoom/SpeechesTestimony/giancarlostatement052616>.

⁵ See *Position Limits for Derivatives: Certain Exemptions and Guidance*, 81 Fed. Reg. 38458 (June 13, 2016) (“Supplemental Proposal”).

a. An Effective and Efficient Federal Position Limits Regime for Commercial End-Users

CMC members are concerned that the Supplemental Proposal would, by rule, negate a number of NEBFH exemptions that have existed for some time. In so doing, the CFTC would seem to prohibit these exemption by rule without any process – except by formal rulemaking – for reconsideration. We urge the Commission to adopt a process that would allow for a full review of existing exemptions for which the CFTC has expressed recent concern.

Going forward, a more prudent regulatory approach would be for the Commission to work with the exchanges regarding a determination of future exemptions. For example, should the Commission decide to maintain its review of exchange granted exemptions, it should limit the time period to issue a decision to overturn an exemption. Likewise, the Commission should consider a meaningful process for commercial end-users to appeal the denial of an exchange granted hedge exemption. Moreover, the Commission should maintain the current exchange process of allowing market participants the ability to apply for a position limit exemption within a specified time after exceeding a limit to account for unforeseen hedging needs of the commercial enterprise.

In addition, the Commission should remove the conditions that a contract be actively traded, and that an exchange have at least one year of experience administering limits for a particular contract in order for an exchange to grant a NEBFH, spread, or anticipatory hedge exemption.⁶ These restrictions are not authorized by the Commodity Exchange Act (“CEA” or the “Act”), create barriers to entry for new exchanges, and discourage the listing of new contracts on existing exchanges. For commercial end-users, it is especially important for the Commission to recognize that if there is a justifiable business need to hedge a new product in excess of federally mandated speculative position limits, it should not impose an absolute prohibition on such a practice. The exchanges, with their expertise, can make a prudent decision as to whether an exemption is warranted.

Furthermore, the final position limits rule should, as proposed in the Supplemental Proposal, provide that the Commission will not delegate to the Director of the Division of Market Oversight (“DMO”) or its staff, the authority to make a final determination as to the exchange’s disposition even if the disposition raises concerns regarding consistency of the Act or presents a novel or complex issue.⁷ If the Commission determines that it is not appropriate to recognize a commodity derivatives position as an enumerated anticipatory *bona fide* hedge, NEBFH, or spread exemption, the ultimate decision on whether to repeal an exchange granted exemption should be made through a vote of the Commission after proper notice and comment procedures.⁸ The final position limits rule should also certify that this part of the rule will not be delegated to CFTC staff.

In the following comments, CMC request modifications to the Supplemental Proposal that will establish the most efficient and effective position limits regime. This comment letter also

⁶ *Id.* at 38509 and 38512.

⁷ *Id.* at 38482.

⁸ *Id.* Request for Comment (“RFC”) 31; and *See* proposed CFTC Rules 150.9(f), 150.10(f), and 150.11(e)

reiterates some of the previous comments raised by CMC that are most vital for our members that utilize the commodity derivatives markets to manage everyday business risk.⁹

III. *Bona Fide* Hedging and the Recognition of Risk

a. Economically Appropriate Risk Management Activities

The preamble to the Supplemental Proposal states that the Commission interprets risk in the “economically appropriate” test to mean price *risk*, and considers rejecting the adoption for a broader interpretation of risk, including execution, logistics, and credit risk.¹⁰ CMC strongly urges the Commission to reconsider this approach. Commercial and end-user firms hedge many types of risks that ultimately bear on the price risk exposures of the firms and their use of the commodity derivative markets. 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. Price relationships are critically important, and at times more so than the absolute value of a particular 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. Moreover, price risk is extremely complex and may include volatility and similar non-linear risks associated with prices. Fundamentally, a transaction to hedge any of these risks in connection with a commercial business should receive *bona fide* hedging treatment. In adopting a comprehensive view of risk, the Commission should not condition *bona fide* hedging treatment as available only when risk crystallizes by virtue of a firm holding a physical position or by entering into a contract. Such a view injects risk into commercial activities as it fails to recognize the constant shifts in factors that affect price risk exposures broadly. Risk is inherent to commercial businesses, and the Commission should encourage commercial and end-user firms to manage risk to the fullest extent possible.¹¹

For these reasons, the Commission should read the term *risks* in CEA Section 4a(c)(2)(A)(ii) to encompass the countless risks facing commercial market participants during the conduct of business, including but not limited to: absolute price risk, relative price risk (which is basis or unfixed risk), calendar spread risk, time risk, location risk, quality risk, execution and logistics risk, credit risk, counterparty risk, default risk, weather risk, sovereign risk, and government policy risk. The Commission should recognize that taking a narrow view of risks will result in a reduction of

⁹ CMC’s comments below supplement its prior comment letters with regard to position limits. For the matters that were not addressed in the Supplemental Proposal, we request that the Commission consider CMC’s prior comments in conjunction with the comments provided below as it adopts a final position limits rule. See CMC Letter to CFTC (Sept. 24, 2013), <http://www.commoditymktcs.org/wp-content/uploads/2014/05/CMC-Final-Anticipatory-Hedge-9.24.13.pdf>; CMC Letter to CFTC (Feb. 10, 2014), <http://www.commoditymktcs.org/wp-content/uploads/2014/05/CMC-Position-Limits-Comment-Letter-2-10-2014.pdf>; CMC Letter to CFTC (July 25, 2014), <http://www.commoditymktcs.org/wp-content/uploads/2014/07/CMC-PL-Roundtable-Comment-Letter-FINAL.pdf>; CMC Letter to CFTC (Mar. 28, 2015), <http://www.commoditymktcs.org/wp-content/uploads/2015/09/CMC-Position-Limits-Letter-3.28.2015.pdf>.

¹⁰ *Id.* at 38463.

¹¹ See CEA Section 3(a) (“The transactions subject to this Act are entered into regularly in interstate and international commerce and are affected with a national public interest by *providing a means for managing and assuming price risks, discovering prices, or disseminating pricing information through trading in liquid, fair and financially secure trading facilities.*”).

liquidity and wider bid offer spreads and credit spreads – inadvertently creating the environment for price disruption the CFTC seeks to prevent. This in turn will lead to wider risk premiums throughout the business channel, which will ultimately be passed along to end consumers who will bear the costs. If the Commission elects not to adopt this approach, it should not expressly reject the approach or adopt a hard prohibition on the broader types of risks that commercial and end-user firms face. Instead the CFTC should allow the exchanges to utilize their market expertise to make a determination as to whether the transaction was “economically appropriate” to the reduction of risk for that particular market participant at that particular point in time.

b. Economically Appropriate Test

CMC reemphasizes that the new interpretation of the “economically appropriate” test in the 2013 Proposed Rule runs counter to long-standing, efficient, and effective hedging practices. The proposal suggests that to qualify for the “economically appropriate” test, an entity has to consider all of its exposures when engaging in a risk reducing transaction and the entity itself cannot take into account exposures on a legal entity, division, trading desk, or even on an asset basis. Rather, all exposure has to be consolidated and then analyzed as to whether or not the transaction reduces the risk to the entire enterprise. This new interpretation substitutes a governmentally imposed one-size-fits-all risk management paradigm for a company doing its own prudent risk management business in light of its own facts and circumstances. Such an interpretation would require commercial entities to build a system to manage risk this way – a system that does not exist today because it does not provide risk management value.

When commercial and end-user firms are *below* the speculative limit, their risk managers evaluate the risks that impact their business and manage those risks in many ways using the most effective and appropriate risk management strategies. Of course, when a firm is *below* the position limit, issues related to hedge exemptions are moot. However, hedge exemption policy is critical when a firm is near, at, or above the limit. While there has been much discussion between CMC members and the CFTC in many forums on the issue of “economic appropriateness” as it relates to hedge exemptions, what CMC is seeking is to allow our members to continue engaging in effective, essential, sound, and appropriate risk management practices when our members are above a particular limit. Hedging strategies and sound risk management do not change whether one is above or below this limit. Our members view risk and risk management the same whether below the limit or above the limit.

This does *not* mean that CMC members are seeking *carte blanche* authority to exceed the limit, to speculate, or to become speculative entities as the CFTC may fear. Rather, we urge the CFTC to recognize that commercial firms utilize risk management tools effectively below the limit and the effectiveness and appropriateness of their application does not change when they are used above the limit. If they are not speculative, as can be shown through the facts and circumstances of the hedging entity, why should they be denied an exemption over a narrower view of risk by the CFTC for positions above the limits as opposed to those below the limits? After all, if the CFTC lowered the limit even further, would an otherwise *bona fide* hedge somehow become less effective or less appropriate simply because the limit was lowered?

CMC’s discussion about the types of risk that the CFTC should recognize in the context of the “economically appropriate” test describes how risk managers look at and hedge risk today *below*

the limit and asks that the CFTC allow those same types of risks to be hedged in a similar manner above the limit so that risk management is not imperiled. We recognize the importance of justifying hedge exemptions, but we believe that the CFTC should recognize the reason and manner in which firms hedge risk and allow them to do so both below and above the position limit.

c. Gross Versus Net Hedging

The Commission uses concepts of “gross hedging” and “net hedging” in its discussion of the “economically appropriate” requirement. However, these terms are not separately defined and the context in which they appear does not fully inform their meaning. CMC understands “gross hedging” to be the practice of independently hedging each of two or more cash market price risk positions. For example, a firm may have three purchase contracts for wheat: one from Russia, the second from Brazil and the third from Australia, and such firm may have one sale contract for wheat, perhaps for delivery in China. Under a “gross hedging” approach, the firm might enter into three short derivatives trades, each to hedge a specific purchase contract, and one long derivatives contract to hedge the sale contract. “Net hedging” happens when that firm nets its purchase and sale contracts to a net long (or short) position and then offsets that residual risk by entering into derivatives transactions reflective of net risk exposure. CMC asks the Commission to (i) remove any references in the proposal that limit the ability of end-users to utilize both “gross hedging” and “net hedging” concepts, and (ii) affirm that each of these methods entail derivatives that would be eligible for *bona fide* hedging treatment. Additionally, when utilizing “gross hedging,” firms should have the flexibility to hedge either the gross long or the gross short when this is the most “economically appropriate” risk management position.

d. Enumerated Hedges

CMC requests that the scope of recognized or enumerated hedging exemptions in any final position limits rule include the full scope of anticipatory hedging activities – in particular, anticipatory merchandising and anticipatory processing hedges, and cross commodity hedges.

i. Anticipatory Merchandising Hedges

CMC appreciates the Commission’s recognition of the importance to farmers, processors, and producers, for the need to access cost-effective hedging to protect against anticipated risks, as Congress intended.¹² 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*.” As can be seen, anticipatory merchandising is statutorily recognized as a *bona fide* hedge in the CEA. However, the Supplemental Proposal does not adequately recognize the important role of merchandisers and their need to engage in anticipatory hedging transactions. Anticipatory merchandising hedges are crucial to the risk management functions of commercial end-users. Merchandising activity enables

¹² See Supplemental Proposal at 38480-38482; and Remarks of Commissioner Bowen before the District of Columbia Bar, (Jan. 12, 2016), (“In my time as a Commissioner, I have spoken with farmers, processors, and others involved in producing the food we eat and the plant-based products we use. . . [g]iven the sizeable capital investments needed and their frequently unpredictable incomes, they need access to cost-effective hedging to finance their businesses. They need to be able to protect against anticipated risks”).

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. Merchandising activity promotes market convergence – which is a crucial aspect of the price discovery function commodity markets serve. Allowing the full scope of hedging activity promotes more efficient, effective, and transparent markets –the exact public policy goals the Commission wishes to promote. Thus, the statutory definition clearly reflects the Congressional intent that anticipatory merchandising transactions should not be subject to federally mandated speculative position limits.

Viewed from a commercial context, energy and agricultural merchandisers build and manage a portfolio of physical supply, storage, and transportation services in order to meet anticipated demand. For most firms, system demand varies dramatically, yet predictably, based on certain economic, weather, or supply factors. Energy and agricultural commodities are exposed to commodity risks, and in general, must forecast the anticipated demand on their systems and assess the underlying physical exposure associated with that demand. Many agricultural and energy companies then determine if the financial instruments are needed to mitigate all or a portion of that exposure. For these reasons, providers need to have hedge exemptions in place that allow for anticipatory hedging well in advance of when their positions may be expected to exceed the applicable limits.¹³

The demand for oil to process in a global refinery system, store in tankage, or arbitrage between one region and the other is constantly changing with the dynamics of the overall market. Many refining systems anticipate their future needs for oil based on economics for refining crude oil into products, which change over time depending on a multitude of factors. The companies purchase crude oil loading in the future to lock in physical and pricing needs, of which some can require hedging in benchmark futures contracts. Further, energy providers consider buying benchmark oil to take delivery for their refining systems to process. As economics change energy providers optimize these crudes and products by selling them and buying others. Consequently, energy providers are regularly planning their forward balances one-to-six months out.

ii. Anticipatory Processing Hedges

The Supplemental Proposal does not affirmatively respond to CMC's concerns previously expressed regarding the anticipatory processing hedge exemption. We recognize that those comments may be fully considered in the context of the Commission's consideration of the 2013 Proposed Rule. For purposes of reiterating our interest, CMC members are concerned with the examples used in the Commission's 2013 Proposal to provide guidance on the applicability of the anticipatory processing hedge exemption. Specifically, the examples suggest that the only way one

¹³ For example, the demand for oil to process in a global refinery system, store in tankage, or arbitrage between one region and the other is constantly changing with the dynamics of the overall market. Many refining systems anticipate their future needs for oil based on economics for refining crude oil into products, which change over time depending on a multitude of factors.

could avail itself of the exemption would be if positions were equally and contemporaneously placed against all legs of the processing hedge activity. For soybean processors, this requirement would be unworkable. There are three legs to the soybean crush hedge – soybeans, soybean meal, and soybean oil. Market conditions dictate the value of hedging the crush and the timing of positions. In fact, there are often instances where the best hedge for one or two of the legs would be no futures position at all.

iii. Cross Commodity Hedges

CMC re-iterates its previous comments to request for the Commission to remove the quantitative factor and the spot month restriction for cross commodity hedging, and instead, to adopt a reasonableness test. We believe that the reasonableness test satisfies the “economically appropriate” standard as cross hedging is particularly important for commodities that may be processed or transformed into products and may not be non-exchange traded commodities.¹⁴

Specifically, the Commission introduced its “substantially related” test in the 2013 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. The Commission suggested a numerical test – a 0.8 correlation coefficient — to qualify a contract for utilization as a cross commodity hedge for a time period of at least 36 months.¹⁵ CMC believes that a “substantially related” test may provide guidance as to whether a cross commodity hedge is “economically appropriate” for purposes of the *bona fide* hedging definition; however, we assert that certain transactions can be recognized as a hedge even if a hedge position does not satisfy the CFTC’s “substantially related” test but is nonetheless “economically appropriate” given the context of the hedge.¹⁶ In both the agricultural and energy sectors, in many circumstances, perfect or near-perfect hedges are not generally available, thus, the Commission should qualify a cross commodity hedge as “economically appropriate.”

For example, over some time periods and across some geographical locations, a hedge of electricity prices using a derivatives contract linked to Henry Hub may, in fact be “economically appropriate,” and the ability to hedge electricity with natural gas is a well-recognized and commercially reasonable cross hedge. Electricity is a commodity that cannot be readily stored and for which many related derivatives contracts have little liquidity, particularly in long-dated out months and at lower volume delivery points. In contrast, natural gas can be stored and related derivatives contracts are often liquid in long-dated out months. Moreover, given that many power plants use natural gas as the primary fuel to generate electricity, the relationship between these commodities is well established. In fact, they are often used together in the form of heat rate transactions to hedge the profitability of a power plant.

¹⁴ For example, Heating Oil futures contracts may be used as a proxy for jet fuel. Likewise, gasoline blenders may use RBOB as a proxy hedge for Reformate, Sabinat, Naphta (various types), Alkylate, Butane, Catgas, Raffinate, PBOB, CBOB, EBOB, and Eurograde gasoline. West Texas Intermediate (“WTI”) crude oil futures contracts are often used as a proxy for numerous grades of crude oil that is produced in North America, and more recently with the repeal of the U.S. oil export ban, oil blenders and refineries globally are using WTI as a proxy hedge against various grades of global crude types.

¹⁵ See 2013 Proposed Rule at 75717.

¹⁶ See Supplemental Proposal at 38468 (“as the Commission has observed, ‘context is essential to determining the nature of any price risk that has been realized and could support the existence of a *bona fide* hedge.’”).

In addition, the Commission's suggested numerical test is inappropriate because it fails to take these and other contextual items, such as the availability, 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 can satisfy the “substantially related” test for the enumerated *bona fide* hedging position exemption or at least be “economically appropriate” for purposes of the NEBFH exemption.

In even a cursory review, examples can be found in which a cross hedge of two contracts with the same underlying commodity would not achieve a 0.8 correlation, such as corn, natural gas, or C5 Diluent contracts delivered in two different locations. Additionally, end-users may need to utilize cross hedging in cases where seasonality impacts the correlation between the two commodities. CMC members believe that a position limits regime where risk managers can freely select their cross hedges, report them as such, and stand ready to explain them to the Commission if necessary is the proper regulatory design. Additionally, exchanges should be permitted to set restrictions on a contract-by-contract basis, recognizing the unique characteristics of each individual commodity and contract, and the need (or lack thereof) for commercial end-users to continue to utilize cross commodity hedges in a specific market during the spot month, near month, or in the last five trading days.

IV. Non-Enumerated Hedge Exemptions and Spread Exemptions

While the Supplemental Proposal delegates to the exchanges the authority to grant NEBFH and spread exemptions, the Commission should authorize the exchanges to grant *bona fide* hedges (“BFH”), NEBFH, and spread exemptions during the last five days of trading or less. CMC asks that the Commission delegate to the exchanges, not only the ability to grant NEBFH and spread exemptions during the last five days of trading, but also the ability to grant exemptions for long-standing hedging practices that were not addressed in the Supplemental Proposal.

a. Prohibition on the Last Five Days of Trading

The Supplemental Proposal requests comments regarding a contemplated prohibition on the granting of hedge exemptions for spreads during the last five days of trading.¹⁷ CMC respectfully opposes this prohibition for the following reasons. First, there appears to be no statutory authority to impose a prohibition during the last five days of trading.¹⁸ Second, a blank prohibition could lead to reduced liquidity across many contracts in various commodity classes. CMC is concerned that the CFTC’s proposed prohibition will undermine futures price convergence with the cash market, and in turn, harm risk management and price discovery.¹⁹ The Supplemental Proposal will remove the

¹⁷ See Supplemental Proposal RFC 20.

¹⁸ See CFTC Rule 1.3(z)(3) (“A *bona fide* hedging position also includes the following specific positions, provided that, *unless approved by a designated contract market or swap execution facility pursuant to § 150.9*, 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”); and *See Definition of Bona Fide Hedging and Related Reporting Requirements*, 42 Fed. Reg. 42748 (Aug. 24, 1977) (“persons wishing to exceed such limits during the five last trading days may submit materials supporting classifications of the position as *bona fide* hedging pursuant to [CFTC Rule 1.3(z)(3)].”).

¹⁹ For example, during the month of February, Merchant (“M”) enters into a contract to sell soybeans loaded

ability and the capacity of commercial market participants to make and take delivery during the time when all market participants agree that convergence between futures and cash occurs.

It is a well-known and well-accepted fact that convergence between futures and the cash market price occurs in many markets during the last days of trading. Convergence and the predictability of convergence are critical to ensuring that the market performs its critical function of price discovery and risk management. If the market fails its convergence task, it fails its price discovery and risk management function. A 2011 USDA-ERS study reviewed the importance of convergence following a period of non-convergence during 2005 to 2010. The study states that “unpredictable convergence undermines confidence in the market’s ability to perform” its important economic functions and “can lead to significant economic damage.”²⁰ The study further states that “unhedged merchandisers and producers face substantial price risks and welfare losses that jeopardize the conventional operation of the food production, marketing and consumption chain,” and that “[w]hen non-convergence is erratic, the timing of the placing and lifting of hedge will impact hedges’ profitability, making hedging risky.”²¹

Each market has its own unique set of fundamentals, market dynamics, and market participants within the delivery period. To the extent that the Commission is concerned about trading disruptions or congestion during the last five days of trading, it already possesses the regulatory tools to ensure that the market and market participants are engaging in appropriate market behavior. It would be overly simplistic to assume that a regulatory change of this magnitude could result in an improved market environment across all contracts regulated by the Commission. CMC is unaware of any analysis that would suggest this change could improve the trading environment for any single derivatives contract, let alone all of them.

and in transit on a vessel shipping mid-April to an international buyer (“B”) at a floating price basis to the May soybean futures contract (“futures”). B has the right to fix their floating price at any time prior to April 15. Prior to April 15, the soybeans that will be loaded out of the Gulf in the last half of April will need to be sourced from soybeans shipped via barge, rail, or truck. Consequently, M will need to use March futures for supply protection. However, since M’s best option for supply protection is via March futures and the sale commitment is priced basis to May futures, M is exposed to calendar spread risk. In turn, M would need to buy the March futures and sell the May futures to manage this risk. As the March contract approaches the first notice day, M will evaluate whether: (i) it is cheaper purchase soybeans in the cash market and to liquidate the March futures; or (ii) to source soybeans by taking delivery of March futures. If at any time during the delivery process M can buy the soybeans in the cash market below the delivery equivalent price (e.g. below the cost of exiting the futures position, loading the soybeans out, and delivering them to the vessel), M should be required to exit the futures position by the exchange. However, as long as sourcing soybeans through the delivery market remains cheaper than purchasing soybeans in the cash market, M needs the ability to continue to hold the March futures positions and to take delivery in order to fulfill its sale commitments. Should the Commission prohibit the exchanges from granting NEBFH and spread exemptions during the last five days of trading, M in the above scenario would be forced to exit its March futures position before the last five days of trading. Accordingly, M is unable to properly utilize the derivatives markets to manage these risks or to fulfill its sales commitments. CMC believes that an exemption for the above scenario should be available via the NEBFH or spread exemption process in a final position limits rule to further enhance liquidity, convergence, and price discovery.

²⁰ Adjemian, A.K., Garcia, P., Irwin, S., Smith, A., *Non-Convergence in Domestic Commodity Futures markets: Causes, Consequences, and Remedies*, U.S. Department of Agriculture, Economic Research Service, Economic Information Bulletin No. 115, (Aug. 2011).

²¹ *Id.*

The Commission's goals of ensuring smooth and orderly markets that are free of congestion and manipulation are best addressed through exchange real-time and T+1 market surveillance, exchange market oversight, and a coordinated response with the exchanges to ensure that market participants who remain in the market during this period of time are doing so for economic and *bona fide* purposes. Instead of a hard prohibition, the preferable path forward would continue to allow exchanges the discretion to provide exemptions based on facts and circumstances at the particular time for a particular market participant. In fact, we simply ask that the Commission preserve existing practices in allowing market participants to apply for a NEBFH exemption during the last five days of trading if an enumerated hedge is subject to the last five day restriction. We believe that preserving existing practices will not increase regulatory risk and will ultimately benefit consumers.

b. Commercially Reasonable Amount of Time

The Supplemental Proposal provides market participants with a “commercially reasonable amount of time” to reduce their positions to comply with position limits for an exchange granted hedge exemption that no longer qualifies upon Commission review.²² Footnote 168 in the preamble reads that the Commission generally “believes such time period would be less than one business day.”²³ If the Commission decides to implement a process to revoke a previously granted exchange exemption, CMC asks the Commission to clarify that a “commercially reasonable amount of time” depends on a number of relevant factors such as the size of the market participants position, risks created by the underlying exposure, and the availability of sufficient liquidity. Further, the exchanges should retain the discretion to determine, based on these factors, the “commercially reasonable amount of time” to unwind and liquidate a position for a particular market participant. This delegation of authority would conserve the Commission's resources and better utilize the expertise of the exchanges.

V. Wheat Parity

CMC continues to ask the Commission to maintain equality between three U.S. Wheat markets, CBOT, KCBT, and MGEX. Currently, they each have the same spot month limits of 600 contracts and the same single-month and all-months-combined limit of 12,000 contracts. The spot months limits are to be updated based upon deliverable supply estimates, however, the proposed regulations to the non-spot month limits would end the limit equality among these three markets. Different limits for the same type (but not necessarily the same variety) of commodity could dramatically impact the growth or potential for risk mitigating strategies between the contract markets. In the case of wheat, this is particularly critical given the nature of the three differing varieties. Having three varieties of wheat not only provides additional opportunities for market participants to reduce risk through spread trades, but also provides opportunity for hedging and risk management by commercial participants between markets in response to domestic or global economic factors that could result in varying impacts on the differing varieties of wheat.

VI. Cash and Carry Positions

CMC supports ICE's comment letter with regard to cash and carry spread (“CAC”)

²² See Supplemental Proposal at 38476, 38509, 38511, and 38513.

²³ *Id.* at footnote 168.

exemptions.²⁴ As the Commission is already aware, CAC exemptions are currently recognized by ICE for contracts involving certain warehoused commodities, specifically, coffee, cocoa, and FCOJ.²⁵ ICE maintains strict procedures that set the terms by which these exemptions may be granted and the spread differential at which the trader will be obligated to liquidate positions, and these procedures have been in place for many years. The availability of CAC exemptions serve an economic purpose in the days leading up to first notice day and throughout the notice period, because the exemptions help maintain an appropriate economic relationship between the nearby and next successive delivery month.²⁶ Among other market benefits, the holder of the exemption provides liquidity so that traders that carry short positions into the notice period without the capability to deliver may exit their positions in an orderly manner.

The important economic function played by this spread exemption in the case of coffee and cocoa is explained by the lack of uniformity of the physical product, which depends not only on the age of the certificate for coffee, but more importantly on its origin, grade, port of storage, harvest season, and the demand for the various combinations of attributes. These differing characteristics mean that commercial hedgers rarely meet ICE requirements for long spot month hedge exemptions because there is no certainty that the certified product they receive will meet the very specific provisions found in their coffee and cocoa commercial contracts. Thus, when there are plentiful certified stocks, this can create an imbalance in the expiring contract month because holders of certified stocks are eligible for short hedge exemptions while few traders qualify for long hedge exemptions. This may result in the nearby spread trading at a differential that is wider than the full cost of carry, which could result in the expiring month failing to converge with cash prices.

In turn, by providing commercial market participants with the opportunity to compete for the ownership of certified inventories beyond the limitations of the spot month position limit, ICE helps to maintain a balanced market and to ensure an orderly liquidation.²⁷ Consequently, the CFTC should allow the exchanges to grant CAC spread exemptions in the last five days of trading, and the conditions on when the market participants must enter and exit positions should be left to the discretion of the exchanges.

VII. Proposed Reporting Requirements for Commercial End-Users and Exchanges

a. Reporting Requirements for Non-Enumerated *Bona Fide* Hedges, Spreads, and Anticipatory Hedge Positions

CMC supports FIA's comment letter²⁸ recommending that the Commission remove the proposed requirement that exchanges adopt enhanced reporting rules for market participants that rely on NEBFH exemptions, spread exemptions, and anticipatory hedge exemptions.²⁹ Generally, most commercial and end-user firms hedge risk on a portfolio basis and do not distinguish between different types of *bona fide* hedging transactions - because a hedge is a hedge. The Supplemental Proposal builds on the Commission's 2013 Proposed Rule and envisages a regime under which

²⁴ See ICE Letter to CFTC (July 13, 2016).

²⁵ See Supplemental Proposal at 38479-38480.

²⁶ See Supplemental Proposal RFC 23.

²⁷ See Supplemental Proposal RFC 24.

²⁸ See FIA Letter to CFTC (July 13, 2016).

²⁹ See Supplemental Proposal RFC 17.

holders of a NEBFH would notify the market when it placed positions into the market in reliance of the NEBFH. Notably, this would be required for each NEBFH held by or relied upon by the market participant. Additionally, the Commission would require such market participants to file cash reports via a new Form 504 that would require the identification of the cash held against each NEBFH position in the market – again separately for each NEBFH held by or relied upon.

The proposed enhanced reporting requirements would require a market participant to alter its current business practices to separately report its NEBFH and anticipatory hedging activity. For instance, market participants would have to invest in costly technology to update their infrastructure to identify each NEBFH and associated cash positions, to adopt a separate internal accounting requirement just for hedging positions, and to report underlying exemption eligible positions to the exchange as frequently as on a daily basis up-to-date information – shifting scarce resources from actual business operations to burdensome and unnecessary reporting obligations.

The same concerns apply to enhanced reporting requirements related to exemptions during the spot period or the last five days of trading, requiring firms to show three years of cash market positions to justify a NEBFH, and requiring market participants holding positions above the speculative limits according to a BFH exemption - enumerated and NEBFH - to report their daily cash positions. As illustrated, these processes would induce undue cost burdens on commercial and end-user firms without any tangible benefits. For the requirement to report daily cash positions, the feasible alternative would be to allow market participants to file a monthly report of their underlying cash positions to the exchange. But as a practical matter, this reporting is unnecessary. Should the Commission require additional information from a market participant, it has the ability to do so via a special call.

We believe the better approach would be to recognize that a hedge is just that – a hedge – and that once granted, NEBFH positions become another factor in determining a market participant’s unified hedge exemption. Currently, market participants holding hedge exemptions in CME agricultural contracts undergo an annual review of their hedge exemptions, a process that includes a historical review of their cash activities. For many of these participants, the hedge exemptions fall short of meeting their actual physical market exposures and reflect exchange interest in maintaining healthy markets. For these reasons, CMC suggests that the CFTC recognize this process and allow the exchanges to grant a single hedge exemption on an annual basis for each market participant, which reflects that participants physical market exposures, as well as NEBFH and anticipatory exemptions collectively. Such a conclusion would also eliminate the need for the additional proposed Form 504 and Form 704 reports, and the Commission could continue its reliance on the monthly Form 204 cash position report.

b. Exchange Reporting Requirements

CMC supports the comment letters submitted by ICE and CME recommending a streamlined reporting regime and authorizing the exchanges to request additional information from a market participant as they deem necessary.³⁰ Presently, exchanges collect the detailed information necessary from each market participant to make an informed decision about an exemption request. Instead of prescribing specific data points as the Supplemental Proposal suggests, the Commission should allow the exchanges to continue its current information gathering process and its market

³⁰ See ICE Letter to CFTC (July 13, 2016); and CME Letter to CFTC (July 13, 2016).

surveillance of applicants. As for reports submitted by the exchange to the Commission, the final position limits rule should only require (i) a weekly report for new NEBFH, spread, and anticipatory exchange granted exemptions,³¹ and (ii) a monthly report for all other reporting requirements.

Additionally, the Commission should clarify that all of the detailed exemption procedures from the Supplemental Proposal are applicable if, and to the extent that, the exchange granted exemption exceeds federally established speculative position limits and not otherwise.³² Depending on where federal limits are set, it is possible that an exchange-set speculative position limit will be lower than the federal limit for particular contracts. Likewise, the Commission should clarify that the detailed procedures for granting exemptions with respect to spread and anticipatory hedges are not applicable to exchange granted exemptions below the federal levels.³³ These procedures are unnecessary for excluded commodities and other products that are not subject to federal limits. Current exchange exemption programs have been operating successfully without the need for such prescriptive rules with regard to the content of exemption applications and the facts and circumstances for which they may be granted. Thus, the Commission should remove the requirements of Section 150.5(b), which apply the exemption procedures of Section 150.9 to exemptions granted for contracts in excluded commodities and physical commodities that are not subject to federal position limits.

c. Commission Review of Exchange Granted Exemptions

Rather than providing the Commission with the authority to review each exchange granted exemption via an exemption-by-exemption process,³⁴ the Commission should continue the current practice of overseeing these exemptions through rule enforcement reviews. Adopting the exemption-by-exemption review process as proposed could be dilatory and deprive market participants of timely and effective risk management, leaving them exposed to price and market volatility. In turn, maintaining the rule enforcement review process will leverage the expertise of the exchanges, conserve Commission resources, and provide market participants with an added layer of regulatory certainty. Moreover, the Commission should limit the time period for overturning an exchanged granted exemption.³⁵

VIII. Conclusion

CMC recognizes the Commission's crucial oversight that fosters transparent, open, competitive, and financially sound commodity markets, and reminds the Commission that the commodity markets did not cause the 2008 financial crisis. In adopting a final rule for federal position limits, CMC urges the Commission to continue to be mindful of its role in protecting the longstanding and crucial ability of commercial end-users to utilize commodity derivatives markets to manage risk. If the Commission fails to act upon the recommendations included within this letter to preserve the crucial risk management function of the commodity markets, the Commission will cause harm to commercial participants and end-users of these markets through loss of market

³¹ The Commission should utilize the expertise of the exchanges and authorize them to determine the information required in weekly reports.

³² See proposed CFTC Rules 150.5(a)(1), 150.2, and 150.3.

³³ See proposed CFTC Rules 150.10, and 150.11.

³⁴ See proposed CFTC Rules 150.9(d), 150.10(d), and 150.11(d).

³⁵ See Supplemental Proposal RFC 18.

liquidity and reduced convergence. This would further serve to increase prices to consumers and decrease prices to producers – harming the American public and the farmers, ranchers, and others who produce commodities.

Thank you for the opportunity to provide comments on the commercial impacts of the changes proposed to the 2013 Position Limits for Derivatives rulemaking. If you have any questions or concerns regarding this letter, please do not hesitate to contact Kevin Batteh at Kevin.Batteh@Commoditymkts.org.

Sincerely,



Kevin K. Batteh
General Counsel
Commodity Markets Council