INSTITUTE FOR AGRICULTURE AND TRADE POLICY

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Secretary to the Commission
Commodity Futures Trading Commission (CFTC) (Commission)
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July 13, 2016

17 CFR Parts 37, 38, and 150
RIN 3038–AD99

Supplemental notice of proposed rulemaking: Position Limits for Derivatives: Certain Exemptions and Guidance[1]

Submitted electronically at http://comments.cftc.gov

Dear Mr. Kirkpatrick,

Introduction

The Institute for Agriculture and Trade Policy (IATP)[2] appreciates this opportunity to comment on the Commission's above captioned Supplemental notice of proposed rulemaking (SN) to the December 2013 position limits rule. IATP is particularly grateful to the Commission staff for its careful explanation of the history of the position limits rule, including how the Commission has delegated its authority to exchanges set and manage position limits. The following letter is oriented towards determining whether and how the proposed SN can be effectively implemented and enforced by the Commission staff under current and foreseeable resource constraints.

IATP last wrote to the Commission on the position limit rule on March 30, 2015, in response to a Request For Comment (RFC) about position limits as discussed in an Energy and Environmental Markets Advisory Committee (EEMAC) Roundtable.[3] Most market participant EEMAC views were hostile to position limits to the point of denying exchange managed position accountability failure in 2007-2009 and doubting the necessity for the Commission to set and enforce position limits.

Nevertheless, the Commission is obliged, under the "Wall Street Reform and Consumer Protection Act of 2010" (Dodd-Frank) authorities, to finalize a position limit rule. The Commission has solicited the views of market participants regarding various exemptions to position limits and position aggregation and has granted many of those exemptions as part of the rule. Chairman Timothy Massad wrote in his concurrence with the SN that he looks "forward to hearing the views of market participants and finalizing a position limit rule this year" (Federal Register, Vol. 81, No. 113, June 13, 2016, page 38514). IATP, not a market participant, questions whether a position limit rule with the exemptions proposed in the SN—such as those governed by proposed changes to the definition of bona fide hedging—can effectively implement the Commodity Exchange Act (particularly CEA section 4a(a)(3)(B))) and Dodd Frank Title VII requirements.

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In the SN, the Commission would retain the authority to review the exchange granted exemptions from position limits (FR 38464) and could use that authority, subject to the Commission's severe resource constraints, to revoke exchange granted exemptions on a case by case basis. IATP raises the issue of resource constraints because they inform the Commission's strategy to rely on Self-Regulatory Organizations (SROs) to implement the position limit rule and other Dodd Frank authorized rulemakings. In a 2014 interview with *Futures Industry Magazine*, Chairman Massad conceded the Commission's reliance on SROs to implement Dodd Frank: "Unfortunately, we don't have the budget I would like to have to really make sure we can be doing all that we should be doing. We've got to rely on the industry to regulate itself, in many respects."[4] The derivatives industry has successfully lobbied a receptive Congress to deny the CFTC the resources to implement Dodd Frank with less dependence on the SROs.

To judge by the unanimous vote to release the SN, the Commission seems inclined to finalize the position limits rule with this new round of exchange managed position limits and exchanged granted exemptions from position limits. Therefore, IATP will focus its comments on how Commission staff might most effectively review the exchange granted exemptions and how exchanges should report exemptions to the Commission. Timely and comprehensive reporting of exempted swaps, futures and options contracts from position limits is a crucial evidentiary basis for the Commission to review to determine the extent to which the Commission should continue to delegates its authority to the exchanges to implement the position limits rule. The SN and the position limit rule more generally does not contain guidance to market participants as to what the Commission could do if exchange managed position accountability fails in numerous contracts to prevent or diminish excessive speculation, and the distortion of price formation resulting from excessive speculation. Providing such guidance, even for a resource constrained Commission, should be part of this SN and a finalized position limit rule.

The Commission's decision to delay compliance with swaps data reporting inclusion in position limits

As of October 28, 2015, the Commission no longer requires exchanges to report Over the Counter (OTC) commodity swaps trading for the CFTC Weekly Swaps Report.[5] In effect, the Commission has adopted the industry view that the swaps are too "customized" to be reported uniformly according to an agreed set of data elements, notwithstanding the Commission's efforts to improve the quality of swaps data reporting (FR, 38459). It is difficult for IATP to discern in the open ended delay that the Commission grants to exchanges from reporting swaps to the Commission (FR 38462), by what means the CFTC will require the exchanges to compel swaps dealers to provide futures equivalent trading data for their swaps to enable position aggregation and monitoring.

Less than three years ago, CFTC Chairman Gary Gensler said of Commission measures to bring transparency to swaps trading, "Every product, without exception, must now be reported—interest rate; cross-currency; foreign exchange; credit index; equity index; and commodities, such as energy and agricultural**.**"[6] Notwithstanding the conversion of many customized swaps into standardized futures contracts,[7] the SN's proposed compliance delay for exchange reporting of swaps data to the Commission is at best a tactical retreat from Chairman Gensler's plan to regulate the swaps markets and prevent future swaps dealer default cascades. IATP agrees with the Commission that "it does seem unlikely that an exchange would implement position limits before acquiring sufficient swap position information because of the ensuing difficulty of enforcing such a limit" (FR 38461-38462). However, we do not find in the SN any proposal to compel swaps dealers to provide "sufficient swap position information" to enable exchanges to set and monitor swaps position limits nor for

the Commission to enforce such limits. Absent such a proposal, the delay on including swap positions in position limits could become a permanent retreat from Dodd Frank implementation.

The Commission has recognized in its margin rule for uncleared cross border swaps that swaps structured and marketed in the United States are often traded on non-U.S. exchanges.[8] Given this rulemaking, IATP is puzzled as to why the Commission has not advocated adoption of the Financial Stability Board's proposed aggregation mechanism for cross-border OTC derivatives data.[9] Adoption of such a cross-border aggregation mechanism by FSB member governments would allay many of the market participant concerns (FR 38460-38461) about the claimed impossibility of U.S. exchanges to know the total swaps positions of an entity and its affiliates for the purpose of monitoring and reporting the positions to the Commission. Delay from compliance with swaps reporting requirements, as proposed by the Commission in the SN, could become ad infinitum, to the great detriment of commercial hedgers in the futures and options markets.

However, the World Federation of Exchanges reports, "Commodity derivatives volumes increased 26 percent in 2015 [over 2014 volumes], exceeding 4.3 billion contracts traded. This growth meant that commodity futures surpassed single stock options to become the most traded class of derivative contract[s] in 2015."[10] Notwithstanding the inability or unwillingness of swaps dealers to report their OTC commodity trades to the exchanges, and hence, via the exchanges, to the Commission, there are no lack of commodity contracts for which exchanges may grant exemptions from position limits.

Proposal to amend the definition of bona fide hedging

Market participants have requested and the Commission has agreed to propose changes to the definition of bona fide hedging (FR 38463) that would facilitate the exchanges' determination of which swap transactions are bona fide hedges exempt from the position limits rule. Two criteria in the definition are proposed for elimination, the "incidental test" and the orderly trading requirement that applies currently to bona fide hedging with futures and options contracts. The SN explains, "The incidental test is a component of the December 2013 proposed bona fide hedging position definition requiring that the risks offset by a commodity derivative position must be incidental to the position holder's commercial operations" (FR, 38462). "Incidental" means "happening or likely to happen in fortuitous or subordinate conjunction with something else," according to the unabridged edition of the *Random House Dictionary of the English Language*. Commercial hedgers' positions are subordinate to their main commercial operation, e.g. airlines transport passengers and cargo. The airlines "incidentally" hedge jet fuels costs by hedging upstream in oil derivatives contracts. By eliminating the incidental test, as the Commission proposes, swaps dealers would be able to claim and exchanges could grant the bona fide hedge exemption from position limits for swaps to which they are counterparties. The swaps dealers would thus benefit by the same exemption that Dodd Frank grants to commercial hedgers.

The consequence of the elimination of the "incidental test" from the bona fide hedging definition likely would be that swaps dealers dominate the open interest to the detriment of commercial hedgers, as they have via commodity index trading (not covered by the position limit rule).[11] The Commission explains that the "economically appropriate test" will be used to determine whether swaps should qualify for the bona fide hedge exemption from position limits and therefore, the incidental test is outdated and unnecessary (FR 38463). However, swaps dealers (typically bank holding companies) that trade physical commodities as a "complementary activity" to their OTC

commodity derivatives trading will claim that the "economically appropriate test" shows that their commodity swaps qualify for the bona fide hedge exemption.

A Commission staff review of exchange granted exemptions of "economically appropriate" swaps from the position limits is a resource intensive process for a staff that has relatively small resources, compared to those of the swaps dealers and exchanges. The incidental test is a bright line test that enables Commission staff to make a prima facie determination about whether a swap qualifies for an exchange granted bona fide hedge exemption. Applying the incidental test will enable Commission staff to make a more efficient use of scarce resources to screen those swaps for subsequent determination as to whether they are "economically appropriate." If the incidental test is eliminated from the definition of bona fide hedging, the Commission will deprive itself of a crucial tool to prevent or diminish excessive speculation in commodities by swaps dealers and other non-commercial traders.

The Commission has agreed to the market participants' proposal to eliminate the orderly trading requirement for futures and options from the proposed definition of bona fide hedging and therefore from the determination of whether swaps are bona fide hedges. Market participants contend, as summarized in the SN, that "in the context of the over-the-counter markets, the concept of orderly trading is not defined, yet the requirement would impose a duty on end users to monitor market activities to ensure they do not cause a significant market impact" (FR 38462). The Commission has been convinced by this appeal for special consideration for swaps markets and swaps dealers.

This is a specious argument, unless you believe that the definition of orderly trading in futures and options markets cannot be applied to swaps trading. Eliminating the orderly trading requirement for bona fide hedging for swaps while maintaining the requirement for futures and options trading would constitute Commission sanctioned discrimination against market participants in futures and options contracts. Furthermore, if trade in futures and options markets requires orderly trading but swaps trading does not, why wouldn't market participants seek competitive advantage by diverting their order flow to swaps markets? The Commission's authority to "prohibit the intentional or reckless disregard for the orderly execution of transactions on a registered entity outside of the closing period" (FR 38464) should be complemented by retaining the orderly trading requirement and applying it to swaps, not by eliminating the requirement.

The market participant commenters propose that the Commission apply the standard of intentional or reckless conduct to determine whether a swap is a bona fide hedge (FR 38463). However, this standard is too narrow to prevent violation of position limits, which can occur systematically, if unintentionally, as commodities trading becomes more automated and subject to algorithmic malfunctions. For example, the Commission's study of two years of futures contract data showed that "ATSs [Automated Trading Systems] were present in at least 38 percent of [agricultural] futures volume analyzed" (Federal Register, Vol: 80, No. 42, December 17, 2013, p. 78826, footnote 6). If the Commission eliminates the orderly trading requirement for bona fide hedging of swaps, IATP cannot foresee how the Commission could use its authority effectively to review exchange granted exemptions for swaps from position limits to prevent or diminish excessive speculation.

Furthermore, in response to the market participant comments, under the position limits rule only swaps dealers and major swaps participants—and not all end users—would have a duty to report their positions to the exchanges, since most end users of commodity derivatives contracts are exempt from position limits under Dodd Frank. In sum, IATP strongly opposes the proposed

amendments to the definition of bona fide hedging, since if the Commission adopts the amended definition, its capacity to review and, if necessary, revoke exchange granted exemptions from position limits will be severely impaired.

Proposed Rules Related to Recognition of Bona Fide Hedging Positions and Granting of Spread Exemptions

The Commission writes "that the proposed rules would require the exchanges: To issue exemptions pursuant to exchange rules submitted to the Commission; to keep records; to make reports to the Commission; and to provide transparency to the public" (FR 38484, footnote 68). These rules concern exchange determination, under Commission review and authority, of exemptions for swaps from position limit rules for non-enumerated bona fide hedges (i.e. hedges that apply to commodity contracts not enumerated in the position limits rule), anticipatory hedging in enumerated contracts and the various forms of "spreads," purchasing and selling of contracts in one commodity within the same delivery month, sometimes in different markets. The Commission notes, "In contrast to the longstanding DCM [Designated Contract Market] experience monitoring position limits on futures contracts and granting exemptions to those exchange-set limits on futures contracts, exchanges generally do not currently administer speculative position limits on swaps" (FR 38467).

Given the aforementioned Commission decision to delay compliance with swaps reporting requirements, IATP does not foresee when the exchanges could or would administer speculative position limits on swaps. Thus the Commission's proposed rules on exchange exemptions from position limits for swaps; on record keeping of those exemptions; and reporting to the Commission about the exemptions are hypothetical for an indeterminate future. Measures to "provide transparency to the public" about swaps trading data and "economically appropriate" exemptions from position limits for commodity swaps likewise remain hypothetical proposals unless and until swaps dealers provide exchanges with their trading data and the exchanges aggregate swaps positions for review by Commission staff.

However, let us imagine a future subjunctive or future perfect world when swaps dealers may have or will have reported trading data to exchanges and the exchanges may have or will have aggregated that data in such a way as to enable Commission staff to determine whether an exemption from position limits was properly granted. How would the Commission review of exchange determinations of non-enumerated bona fide hedging (NEBFH), anticipatory hedging and spread trade exemptions from position limits work? The SN outlines a straightforward review process, both regarding staff initiated and exchange initiated reviews of whether certain swaps qualify for the bona fide hedge, anticipatory hedge or spread trade exemptions from position limits. The Commission is confident that its "long experience" in supervising bona fide hedging exemptions in the futures and options markets, thorough regulatory enforcement reviews, can be readily applied to the supervising of exchanged granted exemptions for swaps from position limits (FR 38469, footnote 126). The exchanges advise the Commission that it lacks the resources to do the daily administration of NEBFH exemptions for swaps and that the Commission should rely on the exchanges for such administration, which the Commission agrees is consistent with its statutory obligations. (FR, 38468-34869).

However, the confidence of the Commission and exchanges in their capacity to determine and supervise the granting of NEBFHs and other exemptions for swaps may become overconfidence. The Commission therefore asks, "Are there any facts and circumstances specific to DCMs that, for purposes of exchange limits, currently recognize non-enumerated positions meeting the general definition of bona fide hedging position in § 1.3(z)(1), that the Commission should

accommodate in any final regulations regarding the processing of NEBFH applications?" (FR 38470, RFC 2)

The main new circumstance that will affect the Commission's capacity to oversee exchange granted exemptions from positions limits, the efficacy of a well-managed position limits regime for swaps and the ability of both the Commission and exchanges to prevent or diminish excessive speculation in commodities, is the increase of High Frequency Trading (HFT) in commodities.[12] HFT positions are usually closed out before the end of the trading day and so are not reportable to the Commission. Combined with the apparent inability or unwillingness of swaps dealers to report commodity swaps to the Commission in the standardized and near real time format required of futures and options trading, the HFT data universe is, at least officially, opaque to the Commission. Granting exemptions from position limits for swaps that are traded by HFT strategies will exacerbate price volatility to the detriment of commercial hedgers by increasing momentum or rumor trading and the costs of hedging in such a price volatile environment. IATP does not believe that the Commission's proposed regulation on automated trading is designed to interact with the position limits rule to prevent or diminish excessive speculation.

It is possible that the Commission and the exchanges could develop a separate process to exempt certain swaps from position limits that would take HFT, or at least automated trading, of commodities into account as a novel factor. (in response to RFC 10, FR 38472). But for the Commission to determine whether such exemptions were "economically appropriate," the Commission would require both open interest swaps data and the intra-day HFT data, aggregated and reported by the exchanges to the Commission. At present, the Commission does not have official access to either kind of data.

Transparency to market participants

"RFC 14: Should the Commission prescribe that exchanges publish any specific information regarding recognized NEBFHs based on novel facts and circumstances?" (FR 38473-38474) IATP believes that the Commission should require that all NEBFH exemptions from position limits should be published, since trade in these exempted contracts can become a competitive advantage for swaps dealers. Publishing is particularly indicated if the NEBFH determinations concern novel factors. For example, if carbon emissions derivatives markets and emissions offset contracts are authorized by the Commission to enter into trade, novel facts will concern the reliability, both scientific and legal, of the underlying assets of those contracts. The reporting of such facts may be germane to documenting and/or evaluating the legitimacy of the exemption granted.

"RFC 17. The Commission requests comment on all aspects of the proposed reporting requirements." (FR 38475). IATP agrees that exchanges should report weekly all exemptions from position limits to the Commission and also agrees on the reporting requirements proposed.

Conclusion

IATP is unable to comment further on the details of the proposed SN. It is very regrettable that Congress refuses to appropriate adequate resources for the Commission to implement the Dodd Frank derivatives title or to legislate to make the CFTC a self-funded agency. The Commission will be greatly challenged to supervise the exemptions from positions limits granted by the exchanges, particularly given the aforementioned challenges in accessing the necessary swaps and HFT trading data needed to verify whether the exchange granted exemptions are consistent with the CEA and Dodd Frank objectives. As the Commission moves to finalize the position

limits rule, IATP hopes that the confidence of the Commission and the exchanges to determine exemptions from position limits for certain swaps is not misplaced. The hedging needs of commercial hedgers cannot be served by the position limit regime if the number and kind of exemptions from position limits result in excessive liquidity, induced price volatility, increased margin costs and the exit from commodity derivatives markets of the commercial hedgers that those markets are supposed to serve. IATP hopes that these comments assist the Commission to at very long last finalize the position limit rule.

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[1] http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2016-12964a.pdf

[2] IATP is a U.S. nonprofit, 501(c)(3) nongovernmental organization, headquartered in Minneapolis, Minn., with an office in Washington, D.C. Our mission states, "The Institute for Agriculture and Trade Policy works locally and globally at the intersection of policy and practice to ensure fair and sustainable food, farm and trade systems." To carry out this mission, as regards commodity market regulation, IATP has participated in the Commodity Markets Oversight Coalition (CMOC) since 2009, and the Derivatives Task Force of Americans for Financial Reform since 2010. IATP has submitted several comments on U.S. Commodity Futures Trading Commission rulemaking, and on consultation papers of the International Organization of Securities Commissions, Financial Stability Board, the European Securities and Markets Authority, and the European Commission's Directorate General for Internal Markets (now Directorate General for Financial Markets).

[3] http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=60394

[4] Will Acworth, "The New Chairman: An Interview with the CFTC's Tim Massad," *Futures Industry Magazine*, September 22, 2014. https://fimag.fia.org/issues/2014-09/the-new-chairman-an-interview-with-the-cftcs-tim-massad

[5] http://www.cftc.gov/MarketReports/SwapsReports/Archive/index.htm

[6] "Remarks of Chairman Gary Gensler before the International Group of Treasury Associations and the U.S. Chamber of Commerce," September 27, 2013.
http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-146

[7] Terry Flannigan, "OTC Swap 'Futurization' Parsed," Markets Media, October 2, 2014.
http://marketsmedia.com/otc-swaps-futurization-parsed/

[8] "CFTC Issues Final Cross Border Margin Rule," May 24, 2016.
http://www.cftc.gov/PressRoom/PressReleases/pr7370-16

[9] "Feasibility Study on Approaches to Aggregating OTC Derivatives Data," Financial Stability Board, September 19, 2014. http://www.fsb.org/2014/09/r_140919/

[10] "WEF/IOMA Derivatives Survey 2015, April 2016, at 26. http://www.world-exchanges.org/home/index.php/research/wfe-research#d

[11] David Frenk and Wallace Turbeville, "Commodity Index Traders and Boom/Bust in Commodity Prices," Better Markets, 2011. http://www.bettermarkets.com/sites/default/files/documents/Better%20Markets-%20Commodity%20Index%20Traders%20and%20Boom-Bust%20in%20Commodities%20Prices.pdf and Kathrine Daugherty and Kel Kelly, "News, Money and Prices: How Money Flows Distort Our Perceptions

of News Reports," Growmark Research, February 25, 2015. http://www.growmark.com/sites/Files/Documents/NewsMoneyAndPrices.pdf

[12] E.g. Gregory Meyer, "Cattlemen lock horns with futures exchanges over market volatility," *Financial Times*, January 25, 2016.