ICE Response to CME's Comment Letter Dated July 13, 2016

We are writing the Commission to clarify certain points raised by the CME Group ("CME") in its response to the Commission's supplemental proposal to the position limit rulemaking ("Supplemental Proposal").[1] CME's claims regarding cash-settled limits are commercially-driven, misleading and incorrectly question the Commission's policies. CME has once again attacked the Commission's six-year allowance of and proposed expansion of the Conditional Limit, creating the false impression of market danger despite commercial need and strong evidence to the contrary. CME has implied that ICE and the CFTC, through its granting and oversight of the current Conditional Limit, are promoting market conditions more susceptible to and incentivized for manipulation. Contrary to CME's incorrect assertions, including claims that higher cash-settled limits would "imperil" the markets and their participants, the Conditional Limit has worked as a model of efficiency for the only contract to which it currently applies: Henry Hub natural gas.

CME makes purely self-interested, commercial arguments to gain a competitive advantage for its listed contracts, ignoring market data showing otherwise and strong demand by commercial market participants for higher cash-settled limits. CME's arguments are undercut by the fact that CME has itself approved Conditional Limits in its cash-settled Henry Hub natural gas contract since 2010, and we are not aware of actual instances in which CME's "concerns" have been born out in reality. Furthermore, none of the CFTC manipulation cases cited by CME to support its argument involve Conditional Limits and nothing in these cases support CME's contention that the Conditional Limits will incentivize and enable manipulation. As demonstrated below, CME's false assertions will be addressed with empirical data, not speculation.

Background on the Conditional Limit:

January 2010, CME and ICE implemented a "Conditional Limit" for financially settled natural gas contracts during the last three days of contract trading. Under the Conditional Limit, a market participant may carry a position in the financially-settled natural gas contracts (ICE H or NYMEX NN) that is up to 5 times that of the physically settled natural gas contract (NYMEX NG) position limit if the participant agrees not to hold a position in the NG contract in the last three days. In the Commission's 2011 proposed and final rulemakings and the 2013 proposed rulemaking on position limits, the Commission codified the "Conditional Limit[2]." The Commission has again stated in the 2013 proposed rulemaking that "the proposed conditional exemption would satisfy the goals set forth in CEA section 4a(a)(3)(B) by: "Eliminating all speculation in a physical-delivery contract during the spot period by a trader availing herself of the conditional spot month limit exemption; ensuring sufficient market liquidity in the cash settled contract for bona fide hedgers, in light of the typically rapidly decreasing levels of open interest in the physical delivery contract during the spot month as hedgers exit the physical-delivery contract; and protecting the price discovery process in the physical delivery contract from the risk that traders with leveraged

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[1] *See Position Limits for Derivatives: Certain Exemptions and Guidance*, 81 Fed. Reg. 38458 (June 13, 2016) ("**Supplemental Proposal**"). The proposal supplements the Commission's December 2013 position limits proposed rule. *See Position Limits for Derivatives*, 78 Fed. Reg. 75680 (Dec. 12, 2013) ("**2013 Position Limits Proposal**").

[2] The Commission stated in the 2011 rulemaking: "[t]he proposed limit maximizes the objectives, enumerated in section 4a(a)(3) of the Act, of deterring manipulation and excessive speculation while ensuring market liquidity and efficient price discovery by establishing a higher limit for cash-settled contracts as long as such positions are decoupled from large physical commodity holdings and the positions in physical delivery contracts which set or affect the value of cash-settled positions."

positions in cash settled contracts (in comparison to the level of the limit in the physical delivery contract) would otherwise attempt to mark the close or distort physical-delivery prices to benefit their leveraged cash-settled positions[3]."

<u>Reasons for a Conditional Limit:</u>

- The Commission has recognized the need for and benefits of the Conditional Limit. The position limit rulemakings reaffirm this policy and recognition that many market participants have a need to pay or receive the final settlement price of the NG contract to perfect their hedges and that this is most effectively accomplished by holding cash-settled futures. Removing or reducing the Conditional Limit would disrupt present market practice for the sole purpose of enhancing CME's competitive position.

- Eliminating or decreasing the Conditional Limit for cash-settled contracts would be a significant departure from current rules, which have the support of the broader market. In the six years since the Conditional Limit provision went into effect, natural gas prices have been lower and less volatile than historical levels. ICE has received no complaints regarding natural gas markets during that timeframe nor are we aware of any complaints received by NYMEX or the CFTC. **The only party advocating for a change in the well-functioning status quo is CME**, who is clearly biased regarding the issue and whose own analysis supporting the change is significantly flawed (as explained in detail below).

- The proposed rule itself will already effectively halve the present spot month limit for cash-settled contracts by converting it to an aggregate limit across designated contract markets ("DCM"), swap execution facilities, and the bilateral over-the-counter ("OTC") market. Further constraining this limit as requested by CME would reduce even further the ability of hedgers to cost-effectively take swaps to final settlement as necessary to perfect their hedges.

<u>CME's Assertions are Flawed and Unsupported by Empirical Evidence or Case Law</u>

<u>Commodity Exchange Act</u>

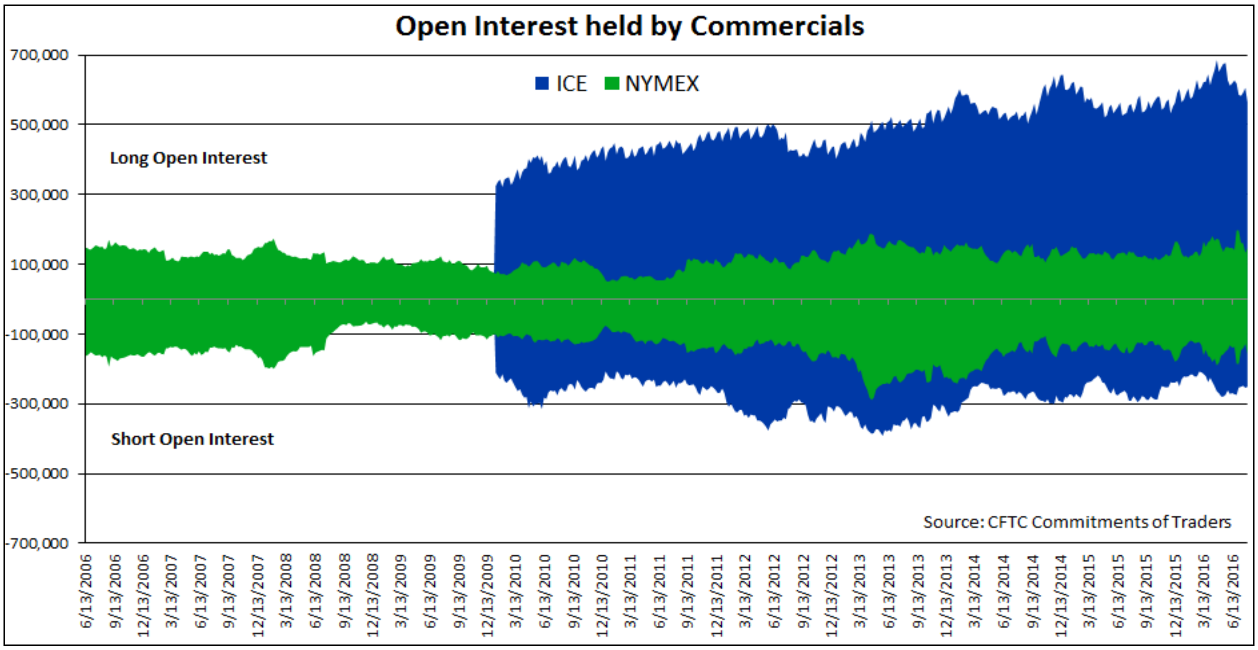
CME claims that:

"In addition to its failure to comply with the "necessity" finding requirement, the Commission has disregarded or misapplied the "appropriateness" standards in CEA section 4a(a)(3)(B),[10] thereby creating a proposed position limit framework that would endanger price discovery and market integrity overall. CME Group is particularly concerned by the Commission's inappropriate and arbitrary favoring of cash-settled contracts to the detriment of the physically-delivered benchmark futures contract."

The Commission recognized the need for and benefits of the Conditional Limit since it has permitted CME and ICE to adopt exchange rules to implement the "Conditional Limit" and has further codified the Conditional Limit in all of the federal position limit rulemakings. If CME believed that the Conditional Limit "vitiates the statutory cornerstones for the Commodity

[3] 78 Federal Register at 75737.

Exchange Act," "endanger price discovery and market integrity overall," and is concerned about the Commission's "favoring of cash-settled contracts to the detriment of the physically-delivered benchmark futures contract," CME would not voluntarily write rules to allow Conditional Limit exemptions to be granted on their markets, would not grant numerous such exemptions and would not list cash-settled contracts side-by-side with their physically-delivered contract. CME is making purely commercial arguments to benefit themselves without any underlying data to support their accusations. In addition, market data shows strong demand by commercial market participants for higher cash-settled limits, as reflected in the below graph depicting open interest held by commercial market participants in the ICE cash-settled and NYMEX physical delivery contract.



Liquidity Drain

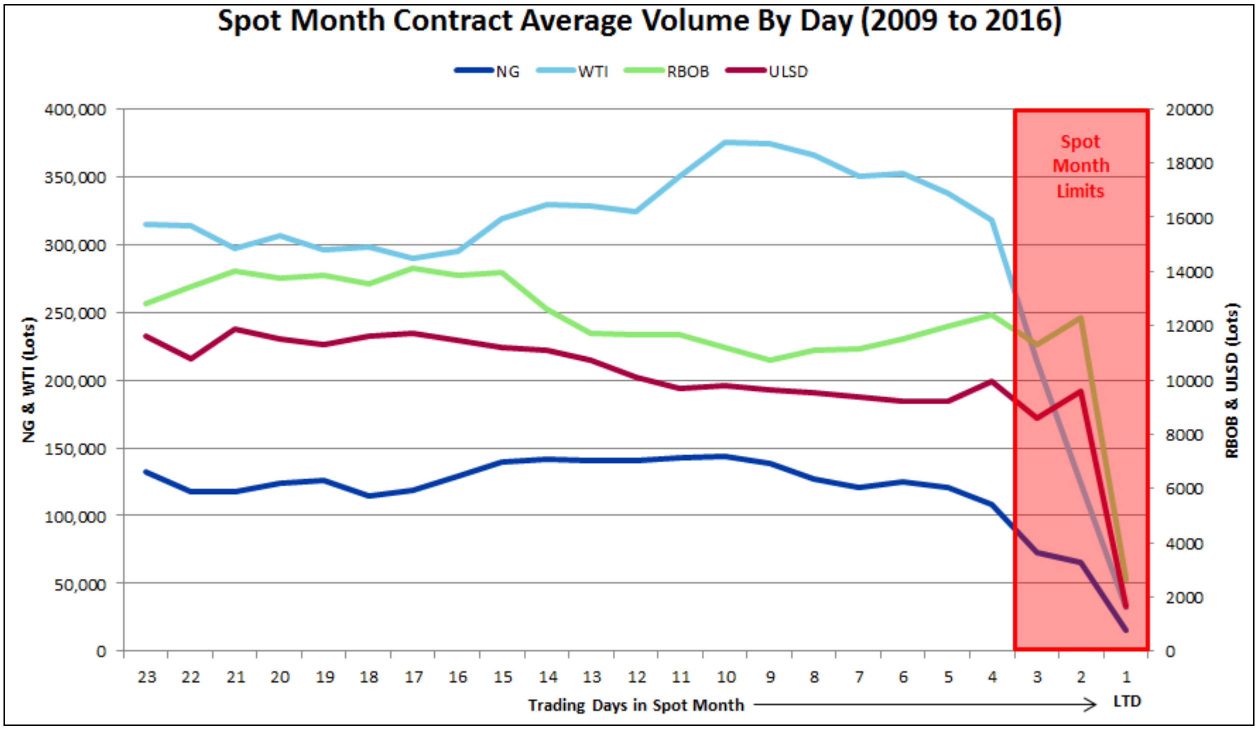
CME Claim:

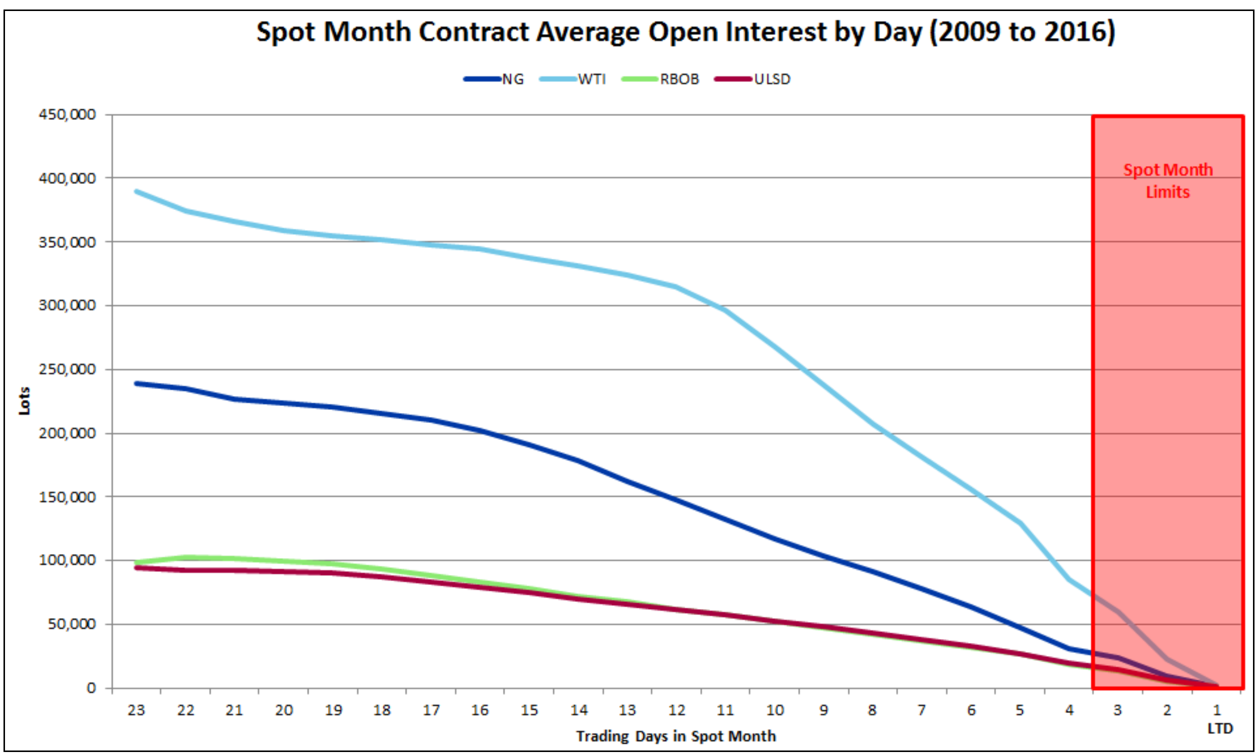
> *"The conditional limit operates to drain liquidity from the physically-delivered contracts. This liquidity drain would prevent physically- delivery markets from serving the price discovery function that they have long provided and that Congress plainly sought to preserve in CEA section 4a(a)(3)(B)(iv). The loss of essential market liquidity would also harm hedgers (and ultimately consumers) in contravention of CEA section 4a(a)(3)(B)(iii).* [1]"

CME's statements are in direct conflict with empirical market data and with ICE's experience. The charts below compare volume[4] and open interest from 2009 (a full year prior to the Conditional Limit coming into effect) through July 2016. As the charts show, volume and open interest for Henry Hub natural gas does in fact decrease as the spot month physically-delivered contract goes into the spot-month limits period. However, the same volume and open interest decrease occurs for CME's other physically-delivered energy contracts, none of which have a Conditional Limit, at the same rate as Henry Hub natural gas. As such, there is no merit to

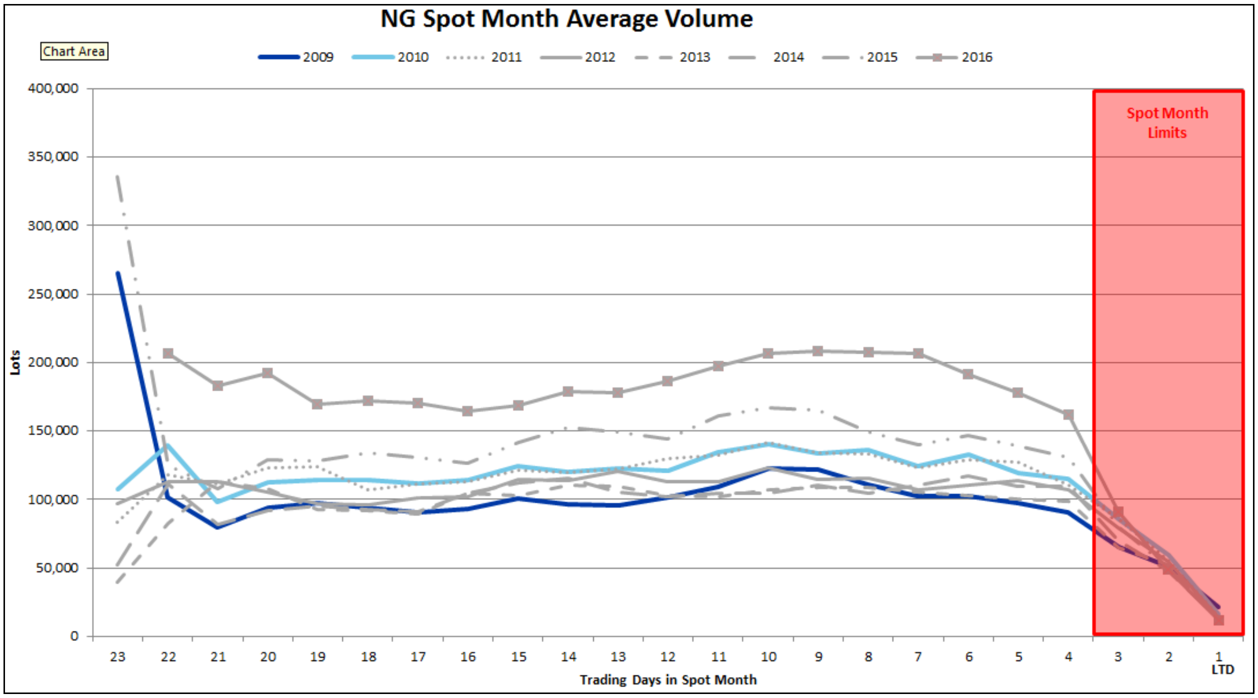
[4] RBOB and ULSD are on a separate axis due to the disparity in open interest with WTI and NG.

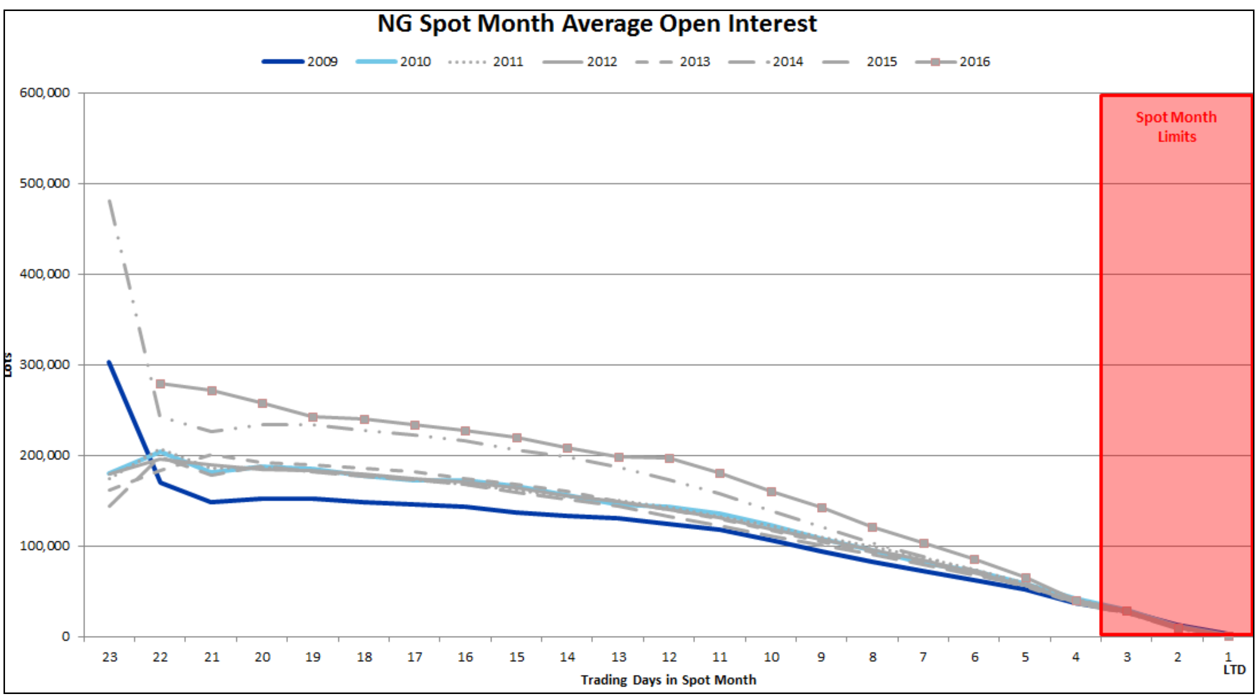
CME's claims that the Conditional Limit operates to drain liquidity from the physically-delivered contracts. As evidenced below, volume and open interest for Henry Hub natural gas and other physically-delivered energy contracts decreases during the spot month due to market participants not wanting to take delivery of the product not because of the Conditional Limit.



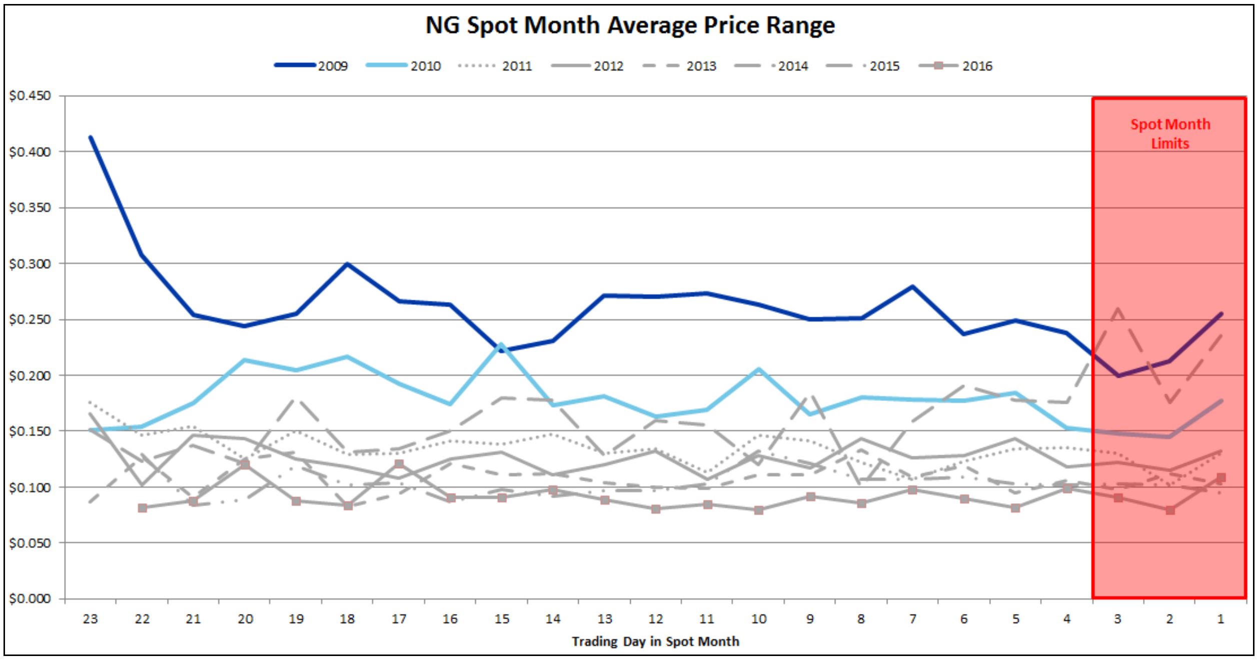


In addition, the charts below further evidence that trading in the NYMEX physically settled contract has actually substantially increased over the past six years – contrary to CME's assertions the Conditional Limit has hurt liquidity. Since the Conditional Limit has been in effect, the NYMEX physically-delivered Natural Gas average monthly volume and open interest have increased. Volume in the spot month contract has also increased each year since 2009, before the Conditional Limit was implemented.





Moreover, prices have been far more stable than historical norms or in the period prior to introduction of the Conditional Limit. There is no evidence that the availability of the Conditional Limit increases speculation or volatility or causes liquidity to drain from physically-delivered contracts. The chart below depicts average price range of the spot month contract over the past several years.



Lastly, as stated in the 2013 re-proposal, “the Commission believes this proposed conditional exemption would not encourage price discovery to migrate to the cash-settled contracts in a way that would make the physical-delivery contract more susceptible to sudden price movements near expiration. The Commission has observed, repeatedly, that open interest in physical-delivery contracts typically declines markedly in the period immediately preceding the spot month. Open interest typically declines to minimal levels prior to the close of trading in physical-delivery contracts.” Empirical data supports the Commission’s and ICE’s belief that the Conditional Limit has no effect on liquidity in the physically settled contract.

Manipulation

CME Claim:

More specifically, though prohibiting the holding of a physically-delivered referenced contract position in the same underlying commodity, the conditional limit would allow for the holding of an unlimited amount of the actual physical commodity.

Generally, the Commission has not viewed limiting the amount of cash commodity a person may hold as an appropriate means to reduce speculation in the futures and swaps markets. Section 4a(a) directs the Commission to impose speculative position limits as necessary on futures, options on futures, and swaps – not on the physical commodities themselves. There are currently no restrictions on the amount of an actual physical commodity a person may hold in the spot month. Neither the proposed rules for limits on positions in physically-settled referenced contracts in the spot-month, nor the proposed rules for limits on positions in cash-settled referenced contracts in the spot month, include limits on cash commodity holdings in the underlying commodity.

CME Claim:

Because actual physical commodity markets are linked to physically-delivered contracts, a trader availing himself of the conditional limit and holding an uncapped physical commodity position would still be able to manipulate physically-delivered contract prices.

In the 2013 Proposed Rule, the CFTC correctly observed that the trading of cash-settled contracts in the spot month presents a reduced potential for manipulation of the price of physically-delivered contracts, and hence should be subject to higher speculative position limits than the physically-delivered contracts:

> "The conditional exemption, as proposed, would constrain the potential for manipulative or disruptive activity in the physical-delivery contracts during the spot month by capping speculative trading in such contracts; however, **in parallel cash-settled contracts, where the potential for manipulative or disruptive activity is much lower**, the conditional exemption would broaden speculative trading opportunity, potentially providing additional liquidity for bona fide hedgers in cash-settled contracts." 2013 Proposed Rule, 78 FR at 75770.

In addition, ICE monitors daily the trading of physical gas on the ICE OTC platform by each market participant holding a Conditional Limit. ICE monitors the physical delivery positions to ensure that market participants do not attempt to influence cash market prices while holding a Conditional Limit exemption.

CME Claim:

The Commission's conditional limit proposal thus does not preclude distortions in the physically-delivered contract, but actually incentivizes and enables a trader qualifying for the conditional limit to manipulate the cash commodity market (and related physically-delivered contract) in order to benefit the trader's leverage cash-settled contract position.

There is no empirical or even anecdotal evidence, based on more than six years of experience with Conditional Limits, that the Conditional Limit has provided incentives to manipulate or enabled manipulation of the cash market or the related physically-delivered contract.

Spot month limits are designed primarily to reduce the ability of a trader to manipulate the price of the contract or underlying commodity. For physically-settled contracts, spot month limits are designed to reduce the potential for corners and squeezes as the physically-delivered contract approaches settlement. The 25% of deliverable supply formula is designed to restrict the *ability* to corner or squeeze the market as the contract goes to settlement, rather than address any *incentives* for manipulation that may exist due to positions in the cash market.

Historically, for cash settled contracts, where there is no possibility of corners or squeezes, neither the level of the deliverable supply nor the amount of positions in the cash market have been a relevant factor in setting the spot month limit. Rather, exchanges have been required to set the level as necessary to "minimize the potential for manipulation or distortion of the contract's or the underlying commodity's price." As the Commission has recognized, a cash-settled contract presents a reduced potential for manipulation of the price of the physically-settled contract, and therefore a higher conditional limit is appropriate.

None of the CFTC manipulation cases cited by CME to support its argument involve conditional limits. There is nothing in these cases that supports the contention that the Conditional Limits will incentivize and enable manipulation. Two of the cases—*In re Dairy Farmers of America*, which involved manipulation of the CME Class III milk futures contract, and *CFTC v. Delay*, which involved alleged manipulation of the CME feeder cattle futures contract—involve activity in the cash market that affected the related cash-settled futures contracts for which CME established the spot month limits. These cases do not provide any evidence that the proposed Conditional Limits will create incentives or the ability to manipulate the prices of either cash-settled or physically-settled contracts.

Excessive Limits

CME claim:

> *"As a preliminary matter, we note that—even absent a conditional limit—the CFTC's proposed ceiling for spot-month limits (i.e., 25 percent of estimated deliverable supply) could yield an excessively high limit when accurate, up-to-date deliverable supply estimates are used.[12] CME Group believes that the 25 percent spot-month limit formula is thus not appropriately calibrated to achieve the statutory objective of "diminish[ing], eliminat[ing], or prevent[ing] excessive speculation [causing sudden or unreasonable fluctuations or unwarranted changes in price]."[13]*

According to CME's recently filed deliverable supply analysis for Henry Hub natural gas, the Federal Limit would be 1200 NYMEX contracts. The Commission has proposed equivalent position limits for physically-delivery and financially settled contracts. The federal limit for financially settled contracts covers all DCMs, swap execution facilities and OTC bilateral swaps. Currently, there are no position limits on OTC bilateral swaps and each DCM imposes its own financially settled contract limit. Market participants are thus able to trade up to the speculative position limit on each DCM without having to net its positions across DCMs and are not subject to any position limits for OTC bilateral swaps. Based on a 1200 contract limit for cash settled contracts, just on the exchange-set limits (and not including the OTC market which currently has no position limits), the federal position limits will be **substantially** less for financially settled contracts in comparison to the current regime. Higher limits for cash settled contracts will merely be preserving the status quo of today.

Conclusion

CME‟s assertions regarding cash-settled limits are commercially-driven, misleading and incorrectly question the Commission's judgment. CME's analysis is materially flawed and the underlying data does not support a change to the Conditional Limit. For the reasons noted above, the Commission should adopt final rules maintaining the status quo and maintaining the Conditional Limit at its current level.