PIMCO

Via Electronic Submission

February 28, 2017

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

Re: Position Limits for Derivatives: Reproposal (RIN 3038–AD99)

Dear Mr. Kirkpatrick:

This letter is submitted on behalf of Pacific Investment Management Company LLC ("PIMCO" or "we") to provide comments to the U.S. Commodity Futures Trading Commission (the "Commission" or the "CFTC") on its re-proposed rules for position limits on 25 energy, metals and agricultural commodity futures, options on futures and economically equivalent swaps (the "Proposal").[1] We appreciate this opportunity to share our comments with the Commission and to build on the previous comments we have submitted to the Commission addressing prior position limits proposals.[2]

Introduction

PIMCO is registered as a commodity pool operator (CPO) and commodity trading advisor (CTA) with the CFTC and an investment adviser with the U.S. Securities and Exchange

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1 Position Limits for Derivatives, 81 Fed. Reg. 96704 (Dec. 30, 2016).

2 *See*, PIMCO Comment Letter to the CFTC, re: *Concept Release on Whether to Eliminate the Bona Fide Hedge Exemption for Certain Swap Dealers and Create a New Limited Risk Management Exemption from Speculative Limits* (May 28, 2009); PIMCO Comment Letter to the CFTC, re: *Proposed Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations* (April 23, 2010); and PIMCO Comment Letter to the CFTC, re: *Proposed Federal Speculative Position Limits for Referenced Contracts* (March 28, 2011).

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Commission. As of December 31, 2016, PIMCO managed approximately $1.47 trillion in total assets, and approximately $387 billion in CPO assets, on behalf of millions of individuals and thousands of large institutions in the United States and globally, including state retirement plans, unions, university endowments, corporate defined contribution and defined benefit plans, and pension plans for teachers, firefighters and other government employees. Our services are provided through the management of separate client accounts, in accordance with the specific investment styles and objectives specified by the client, and through the management of mutual funds that are offered to institutional and individual investors. In the case of all of these management services, we are solely engaged in the long-term investment management of our clients' assets, in accordance with the full legal duties of a fiduciary. We do not engage in proprietary trading for our own account nor directly hold client funds, nor provide balance sheet lending to our investment clients. Our principal goal is to make sound, long-term investments that will meet our clients' objectives and provide them with stable and acceptable returns that are consistent with their risk preferences over their desired time horizons. In this context, our commodity index based mutual funds allow investors to invest in a diversified basket of commodities, without affecting or intending to affect or disrupt any particular market or commodity.

Efficient, competitive, liquid and deep (*i.e.*, resilient liquidity that does not disappear or reduce significantly during times of volatility) futures and swaps markets are essential to our business and the businesses of many other market participants. Accordingly, we are supportive of policies that seek to ensure that all markets and contract months have sufficient liquidity and capacity to meet the investing, risk management and hedging needs of our clients. Thus, we support the continuing efforts of the Commission to ensure that the price discovery function of the commodity derivatives markets is being performed in an efficient way and that accommodates all market participants. However, we caution the Commission against adopting an overly broad and restrictive position limits rule, which would have a negative impact on markets and market participants by limiting liquidity, increasing volatility, and ultimately weakening the ability of commercial market participants to use these markets for their hedging and risk management needs.

Comments on the Proposal

PIMCO believes that the Commission should reconsider the adoption of position limits for additional core reference futures contracts and economically equivalent swaps, as set forth in the Proposal. If the Proposal is adopted in its current form, it would significantly restrict the ability of PIMCO's clients, which as noted above include millions of individuals and thousands of large institutions in the United States and globally, and the many other important and significant market participants to use and provide liquidity to commodity derivative markets for effective risk management, investment and hedging purposes. Therefore, we believe that the

Commission must re-evaluate each of the following issues prior to its consideration of finalizing the Proposal:

1. *The Proposed Position Limits Are Neither Necessary Nor Appropriate.*

Commodity position limits impose real costs and regulatory burdens on market participants, such as limiting trading, compressing liquidity and market depth, and contributing to increases in volatility, each as described in greater detail below. These are real costs that will ultimately be borne by PIMCO's clients and similarly situated investors that utilize the U.S. derivatives markets. From that perspective, and our perspective as active users of these markets, we believe that any benefits that would come from the imposition of position limits must clearly and demonstrably outweigh the increases in regulatory cost and burden on market participants that would come from the imposition of position limits. Given the real and extensive cost of position limits, we remain of the view that any position limits proposed by the CFTC should only be adopted if it is demonstrated that such limits are necessary for and appropriate to diminish the burdens on interstate commerce of excessive speculation, which the Commission has not identified with sufficient particularity and supporting empirical evidence.

In particular, the Commodity Exchange Act (the "CEA") provides that "excessive speculation . . . is an undue and unnecessary burden on interstate commerce," and that the CFTC "shall" adopt position limits "as the Commission finds are *necessary* to diminish, eliminate, or prevent such burden[.]"[3] Before the Commission moves forward with expanding the current position limit framework, it is important that it first establish a clear and definitive record to support the required conclusion that position limits are necessary to address specific problems related to the burdens on interstate commerce of "excessive speculation." However, instead of addressing and seeking to satisfy this admittedly vague statutory requirement, the current Proposal attempts to salvage a rule structure that has already been overturned by the courts in one instance and that has now been re-proposed, supplemented and re-proposed again through a cumulative body of CFTC releases that span thousands of pages. Despite the volume of material that has been produced, the Proposal still does not adequately demonstrate that position limits, as a regulatory tool, are necessary to curb the burdens on interstate commerce of excessive speculation or that the additional limits are the appropriate (and least invasive) solution for or response to any specific risk, problem or inefficiency in the commodity derivatives markets.[4]

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[3] CEA section 4a(1); 7 U.S.C. § 4a(1). The CEA also directs that the CFTC only set limits "as appropriate…[and] to the maximum extent practicable, in its discretion: (i) to diminish, eliminate, or prevent excessive speculation…; (ii) to deter and prevent market manipulation, squeezes, and corners; (ii) to ensure sufficient market liquidity for bona fid hedgers; and (iv) to ensure that the price discovery function of the underlying market is not disrupted." CEA section 4a(3); 7 U.S.C. § 4a(3).

[4] Moreover, the numerous proposals have introduced a troubling element of regulatory uncertainty that itself limits the ability of market participants to plan for future business activities.

Importantly, the Proposal also does not identify or attempt to provide (nor did the CFTC's previous position limits proposals) any definition of "excessive speculation," whether in theory or as derived from statistically significant empirical studies, which is the primary statutory purpose for which the CFTC can justifiably implement position limits. Absent this statutorily required specific finding, based on empirical evidence, that positions limits are necessary and appropriate to address the burdens on interstate commerce of excessive speculation, the CFTC should not move forward with adopting the Proposal in its current form.

2. *<u>Non-Spot-Month Position Limits Are Not Necessary.</u>*

As discussed above, it is important that the Commission only adopt non-spot position limits if it has clear empirical evidence indicating that non-spot month trading has led to the defined burden on interstate commerce of excessive speculation. The Proposal highlights only the hypothetical risk of "creat[ing] the perception of a nearby shortage of the commodity which a speculator could do by accumulating extraordinarily large long positions in the nearby month."[5] While PIMCO supports the CFTC's efforts to ensure that commodity markets are fair and orderly and facilitate the deepest trading activity and risk management functions of all market participants, the imposition of new position limits "prophylactically" is not a legally permitted basis from which to impose position limits as a matter of law. Before moving forward, the CFTC must first identify the specific burdens on interstate commerce and the excessive speculation that causes such burdens, as proven by demonstrating a statistically meaningful degree of correlation.

The CFTC should not implement non-spot-month position limits in the absence of a data driven record demonstrating that non-spot-month trading materially and negatively impacts commodity and commodity derivatives markets in the context of liquidity, depth, volatility, the ability to hedge or otherwise. In addition, the Commission has not identified specific concerns regarding manipulation or disruptions in the non-spot-month resulting from large positions. To that end, and although the Commission continues its agency-wide efforts to improve data collection and analysis,[6] the CFTC's data quality remains lacking in several areas.[7] Therefore and in the first instance, the CFTC should refrain from pursuing non-spot-month position limits. Second, it must collect sufficient data to statistically affirm with high statistical certainty that: (i) a direct and incontrovertible connection exists between the regulation of position limits in the non-spot month and reducing the burdens on interstate commerce of excessive speculation[8] and (ii) the CFTC can continue to establish a clear record of multiple

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[5] Proposal at 96722.

[6] Proposal at 96721.

[7] For example, the CFTC continues to work on substantial changes and improvements to both its swap reporting and large trader reporting rules.

levels and studies of empirical support for implementing non-spot-month position limits going forward on a market-by-market basis.

The Commission also should recognize and carefully consider the impact that non-spot month limits will have on reducing market depth in more distant contract months, and whether such an impact comports with the CFTC's mandate to protect price discovery, and facilitate deep and liquid markets.[9] As the Commission is aware, preserving market depth in outer contract months facilitates the ability of market participants to manage their risk farther out the contract curve and is a crucial element of PIMCO's ability to manage its client portfolios. In addition, from a historical perspective, enforcement actions involving manipulation due to large positions (when observed), have generally been associated with spot month trading and contract expiration. The same has not been true in the outer contract months. If market participants are limited in the positions they can hold across all months, the decrease in liquidity will increase the price of hedging for commercial participants who are seeking to protect long-term price risk by trading in outer contract months.

Similarly, given the loss of liquidity and market depth (*i.e.*, impact to price discovery), and increase in prices in commodity markets and the significant financial and regulatory burdens that non-spot month limits will impose on market participants, it is critical that the CFTC, before finalizing any proposal, undertake a thorough and statistical cost/benefit analysis assessing the impacts and costs of non-spot month limits on markets and market participants.

Accordingly, if the Commission moves to adopt a position limits rule, it should substantially depart from the Proposal and focus only on issues relating to manipulation and market disruption around contract settlement and delivery (*i.e.*, physically delivered commodity futures contracts during the delivery period for that contact).[10] The risk of market disruption, by way of a "corner" or "squeeze," is relevant for practical purposes solely in the delivery period, which is when the futures market prices converge with the underlying physical commodity or reference markets.

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[8] For example, the CFTC cites studies such as the Permanent Subcommittee on Investigations of the U.S. Senate, Committee on Homeland Security & Governmental Affairs study "Excessive Speculation in the Wheat Market" from 2009, which found that speculation existed in the wheat market while the price of wheat was fluctuating but academically and statistically failed to demonstrate any causality between excessive speculation and unwarranted changes in commodity prices. Proposal at 96727, n. 260.

[9] *See*, CEA Section 3, 7 U.S.C. § 3(a).

[10] Note that the actual delivery period is a narrower time period than the "spot month" time frame that would be covered by the Proposal.

3. *Position Limits Should Not Apply To Swaps Or Financially Settled Futures.*

Consistent with the discussion above relating to non-spot-month limits, the CFTC should not apply position limits to swaps or financially settled futures contracts. Unlike physically settled spot-month futures contracts, which lie at the intersection of the physical and financial markets, there is no practical risk of using an outsized speculative non-spot position in a swap or financially settled futures contract to squeeze or corner the underlying physical commodity market because a financially-settled swap position does not force other market participants to make or take delivery of the underlying physical commodity. Instead, the primary impact of position limits on cash-settled commodity swaps and futures contracts is to reduce market liquidity and depth across the curve and to necessarily increase transaction costs for commercial market participants, thus reducing their ability to hedge commercial risks, with no related benefit.

4. *Commodity Index Contracts Should Not Be Subject To Positon Limits.*

PIMCO agrees with the CFTC that a position in a commodity index contract should not be subject to position limits. PIMCO clients seek access to commodity index contracts in order diversify their portfolios and to invest in and manage other risks related to a diversified basket of commodities, without affecting or intending to affect or disrupt any particular market or commodity. By using these financially settled derivatives products that track (rather than impact) the underlying markets, diversified commodity index investors are able to establish net-long positions in the commodity derivatives markets to either (i) hedge against broad based commodity, inflation and financial risk that naturally exists elsewhere in their portfolios or (ii) otherwise take a view on commodity markets. These investors, including PIMCO on behalf of its clients, are not taking "directional bets" on individual commodities, and therefore these products must properly remain fully excluded from the application of any position limits rules.

5. *Risk Management Exemptions Should Continue To Be Recognized for Position Limits Purposes*

Any position limits rule that is adopted should include a "Risk Management Exemption" for positions taken to manage financial and other risks faced by a market participant. The CFTC and the exchanges have recognized risk management exemptions from positon limits for decades, without incident, and the CFTC should affirm that its positon limit rules will expressly permit market participants to use the commodity derivatives markets for valid risk management purposes. Specifically, the exchange risk-management exemption that is recognized in the Proposal should be available not only for excluded commodities, but should be available for all commodities. Absent actual market problems or inefficiencies associated with, or attributable to, legitimate risk management hedging practices (none of which have been statistically identified), the CFTC's rules should include a robust risk management exemption

that encourages the hedging activities traditionally taken with respect to commodity index contracts and other similar exposures.

6. *Cross-Commodity Netting Should Be Permitted*.

PIMCO appreciates those aspects of the Proposal that would permit cross-commodity netting in certain instances related to spread positions. However, the Proposal is too prescriptive with respect to cross-commodity netting, generally. Given the strong correlative relationships between certain commodities, any final position limits rule must permit cross-commodity netting in a way that recognizes more generally the very beneficial hedging and risk management market practices used by market participants. The conditions applicable to cross-commodity netting must not unreasonably restrict these risk management and hedging practices by requiring, for example, an artificial quantitative threshold correlation factor. PIMCO understands the difficulty of setting and calculating a single measure for the requisite level of correlation sufficient to permit cross-commodity netting in all instances, and we therefore believe that the rule should instead direct a market participant to evaluate for its own purposes (in coordination with exchange review that should be available upon request), in the context of its own positions and risk management structure, whether particular commodity sets include similar and offsetting risks. The review should be subject to an obligation to respond to any inquiry, whether from the CFTC or an exchange, related to that evaluation.

7. *The CFTC Should Adopt The Higher Proposed Limits For The Legacy Contracts*.

The Proposal would increase certain of the CFTC's existing position limits for nine legacy agricultural commodity futures contracts. PIMCO believes that the CFTC should adopt increased position limits for the legacy contracts and examine further increasing all of those limits to enhance market depth. The CFTC has not revised the limits in over 5 years, and the current limits do not accurately reflect the increases in open interest that have transpired over the years. Increasing the existing levels to the new limits set forth in the Proposal will encourage and promote additional liquidity and depth in these contracts and will thus decrease the likelihood of disruptive volatility and concomitant decrease in both open interest and depth. Moreover, the increased limits will provide new and more resilient hedging capacity for commercial market participants, particularly those seeking to hedge longer term exposures beyond the spot month. Therefore, PIMCO believes that the Commission should finalize the proposed increased limits for the legacy agricultural commodities (limited to futures) as soon as is practical and consider whether additional increases are warranted. The Commission should do so via a stand-alone action that is not dependent on the Commission's timeline for its continued work on position limits more broadly. The proposed preliminary increased limits are as follows:

Contract	Existing Spot Month Limit	Existing Single & All Month Limit	New Spot Month Limit	New Single & All Month Limit
Corn and Mini-Corn (CBOT)	600	33,000	600	62,400
Oats (CBOT)	600	2,000	600	5,000
Soybeans and Mini-Soybeans (CBOT)	600	15,000	600	31,900
Wheat and Mini-Wheat (CBOT)	600	12,000	600	32,800
Soybean Oil (CBOT)	540	8,000	540	16,700
Soybean Meal (CBOT)	720	6,600	720	16,900
Hard Red Spring Wheat (MGX)	600	12,000	1,000	12,000
Cotton No. 2 (ICE)	300	5,000	1,600	9,400
Hard Winter Wheat (KCBOT)	600	12,000	600	12,000

8. If Adopted, Position Limits Should Be Phased In.

To the extent that the Commission finalizes any position limit rules, the effective date of any such rules (other than rules increasing the position limits for the legacy agricultural contracts) should be at least 12-months following the publication of the final rule in the Federal Register. This additional period is required in order to give market participants time necessary for system builds, risk modeling and the establishment of new compliance procedures and monitoring programs—all of which are required and must be rolled out prior to complying with a new rule program.

9. *Coordination With Foreign Regulators To Avoid Differing Compliance Requirements.*

The Commission should coordinate and collaborate with foreign regulators to avoid global market participants becoming subject to conflicts of laws, different compliance requirements, and different compliance timelines for the same or similar products.[11] Global collaboration has been highlighted as a priority by Acting Chairman Giancarlo,[12] and it is extraordinarily important that the Commission and European, Asian and other regulators remain coordinated on their respective position limit frameworks, informed and led by thoughtful U.S. regulation. Global firms such as PIMCO (and our millions of clients and investors on whose behalf we invest) would face significant challenges, burdens and costs, with no related benefits either to investors or markets, if they are required to comply with substantially different position limits regimes, which could result in PIMCO pulling back market liquidity. Moreover, an uncoordinated approach to position limit rules likely affect U.S. market participants and their ability to access liquidity, because overly restrictive U.S. rules could discourage non-U.S. market participants from trading on U.S. trading venues.

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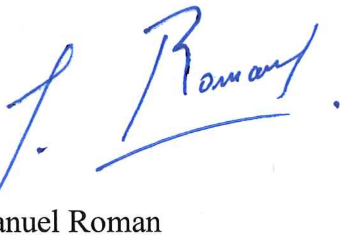
Thank you again for the opportunity to share our thoughts on the Proposal with the Commission. We are at the disposal of the Commission to provide additional information and our insight into the valuable and growing role that the commodities derivatives markets serve for PIMCO, its clients and the depth and functioning of the marketplace.

Sincerely,



Emmanuel Roman
Managing Director, Chief Executive Officer
Pacific Investment Management Company LLC

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11 For example, the Commission should clarify that if over-the-counter swaps are ever subject to CFTC position limits, only those swaps entered into by U.S. entities would be eligible for review by the CFTC for CFTC position limits purposes.

12 *See* Keynote Address of Commissioner J. Christopher Giancarlo, SEFCON VII, January 18, 2017 ("Regulators must set limits on the cross-border application of swaps rules to achieve the ends of market reform in a spirit of cooperation and deference.").

Cc: J. Christopher Giancarlo, Acting-Chairman
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