Copperwood Asset Management LP

February 28, 2017

Submitted Electronically

Mr. Chris 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:

Copperwood Asset Management LP ("Copperwood" or "we") appreciates the opportunity to provide comments to the U.S. Commodity Futures Trading Commission (the "Commission" or "CFTC") on its re-proposed rules for position limits (the "Proposal").[1] Copperwood is an asset manager and active participant in the natural gas and energy markets. This letter builds on and incorporates our comments previously submitted to the Commission addressing its position limits proposals.[2] Based on our review of the Proposal, we observe that a number of concerns from our previously submitted comments have not been adequately addressed. We therefore respectfully urge the Commission to reconsider several aspects of the Proposal in order to avoid significant harm to natural gas and energy markets and market participants. The Proposal, if adopted as a final rule, will result in negative disruption to market structure via contractions in liquidity and increased volatility that will ultimately impose new costs on commercial hedgers and consumers. We specifically encourage the Commission to:

1) Abandon those aspects of the proposal that would impose position limits outside of the spot month;

2) Raise spot month position limits on physically settled energy contracts to reflect global supply availability;

3) Exclude financially settled contracts from the proposed position limits;

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

[2] Copperwood Comment Letter to the CFTC, re: *Position Limits for Derivatives* (December 22, 2014).

4) To the extent that any final rule does apply to financially settled contracts, all instruments that expire on the penultimate day should be excluded from any spot month limits; and

5) Clarify that any conditional spot month limits for financially settled contracts (if limits are to apply to financially settled contracts) will not affect the ability to otherwise take positions (up to the applicable limit) in physically settled contracts.

1. Position limits should not apply outside the spot month.

While acknowledging a variety of comments recommending that position limits should not apply outside the spot month,[3] including our own previous comment, the Proposal retains limits on non-spot month positions. The Commission has not demonstrated that position limits will have any meaningful impact outside of the spot month. The spot month is where the discipline of delivery applies, whereby market participants holding long and short positions must be prepared to take and make delivery, and is where the potential for abuse—by way of a corner or squeeze or other congestion—might present actual disruptions to markets. Importantly, the Proposal fails to offer meaningful necessity and appropriateness findings with respect to non-spot month limits, and the CFTC has not identified any statistically relevant empirical evidence indicating that non-spot month trading has led to excessive speculation and an associated "burden," as is required under the Commodity Exchange Act. Additionally, the Commission lacks the data necessary to accurately set appropriate position limits outside of the spot month. Although we acknowledge the "significant, agency-wide efforts to improve data collection"[4] and analysis, the data relied on by the Commission in the Proposal is far from complete and cannot be used to support the imposition of limits as proposed.[5] Therefore, instead of seeking to impose non-spot month position limits, the Commission should focus on (i) enhancing the quality of the swaps market data and other data that it does receive, (ii) continuing to develop its understanding of the changes in for the futures and swaps markets that have occurred since the implementation of the Dodd-Frank swaps rulemaking programs, and (iii) considering how to use and improve the existing tools that the CFTC has at its disposal to address speculative activity outside of the spot month, including surveillance capabilities, special call authority and authority to oversee DCMs and SEFs.

2. Spot month limits for physically settled energy contracts should be raised to incorporate a global view of available supply.

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[3] See generally, Proposal at n. 560.

[4] Proposal at 96721.

[5] The CFTC concedes that they are still "concerned about the quality of data submitted in large trader reports pursuant to part 20 of the Commission's regulations." Proposal at 96759.

Although we appreciate the Commission's thorough consideration of comments received regarding the calculation of position limits at 25% of "deliverable supply,"[6] including our own, the spot month position limits in the Proposal are arbitrary and too low and the Proposal still does not clearly articulate how the Commission intends to actually calculate deliverable supply. The Proposal, while discussing the applicable levels and manner of calculation at length, largely re-proposes the approach of earlier proposals. Moreover, this approach arbitrarily applies the same spot month position limit methodology across all commodities despite there being no basis in law or in the commodity markets covered by the Proposal suggesting that 25% of deliverable supply would be the appropriate spot month position limit level for all of these commodities. Our concern is that the Commission's approach to determining deliverable supply fails to account for the global character of modern commodity and derivatives markets and also fails to account for the unique nature of each of these markets.

The estimation of deliverable supply should include supply that is available at other major locations, in addition to the specific futures delivery location, to avoid being overly restrictive for hedging purposes and ignore the realities of the scope of commodity and derivatives markets. For example, the NYMEX Natural Gas Henry Hub contract (NG) is a global benchmark and is used by market participants in their global risk management programs. Therefore it should not only be considered relevant for natural gas supplies that are available for immediate delivery at or near Erath, Louisiana. Setting position limits on this contract by taking an arbitrary percentage of deliverable supply estimate, without also considering supplies that are available at other major delivery points and pipelines, will result in a spot month limit that is artificially low and restrictive. Additionally, the concept of "estimated deliverable supply" is still too ambiguously defined without a clear process for its calculation going forward. Spot month position limits, if adopted, should be at levels higher than those in the Proposal in order to ensure sufficient headroom in the spot month for market participants providing the liquidity that is used by commercial market participants for bona fide hedging purposes. Any Commission spot month position limits should also be tailored to the character of the specific commodity market to which they would apply instead of trying to use the same blanket percentage across all commodities. The Commission should abandon the concept of using a single deliverable supply percentage threshold for all commodity markets and modernize its methodology for the deliverable supply calculations being made.

3. Position limits should not apply to financially settled contracts.

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6 Proposal at 96770.

For the same reasons discussed in connection with limits outside the spot month, the CFTC should not apply position limits to financially settled contracts. Financially settled contracts are based on the price of an underlying commodity, merely tracking, rather than having any direct influence on, the price of the underlying commodity. In addition, historically, financially settled swaps contracts are held into expiration without having any impact on physically settled futures; thus the discipline of delivery never applies to them. There is no conclusive evidence of a positive correlation between trading volume and volatility. For example, despite a steady increase in financial trading volumes and open interest, the price volatility of natural gas has steadily declined.[7] Therefore, the opportunity or ability to use an outsized position in a swap or financially settled futures contract to squeeze or corner the underlying physical commodity market is extremely remote. As such, position limits on cash-settled commodity contracts are neither necessary nor appropriate, nor will they contribute to or advance the CEA's goal of deterring and preventing price manipulation or any other disruptions to market integrity. The primary impact will be to reduce market liquidity and *increase* volatility, and increase transaction costs for commercial market participants (who will see their ability to use these markets for hedging commercial risk diminished) with no related benefit. Commercial hedgers require a deep and active market in order to meet the hedging demand of the industry and to ensure that the market is reflective of fair value in the forward curve. Position limits restrict the number of counterparties and size of positions potentially available as participants come up against their respective limits. This reduction in supply would necessarily affect hedging costs, and would be exacerbated by the asymmetric risk of producers being short versus certain commercial users being long and the often highly imbalanced nature of the risk that producers seek to hedge. That is, producers tend to hedge more at high prices while commercials generally try to avoid locking into a high price environment.

To the extent the Commission nonetheless determines to subject financially settled contracts to position limits, it should use a limit that is significantly higher than, and several multiples of, the corresponding limit for the related physically settled contract. In addition, the Commission should ensure that such limits, if they are to apply, would only apply to financially settled instruments that are settled on the same day as the related physically settled contract. Financially settled instruments that settle prior to the settlement of the physically settled contract should not be subject to position limits. To do otherwise and include financially settled contracts in the spot month position limit calculation would fundamentally diminish the ability of market participants to provide liquidity in these products.

[7] See Testimony of John D. Arnold, CFTC Hearings to Discuss Position Limits, Hedge Exemptions and Transparency for Energy Markets, August 5, 2009.

4. ***To the extent that any final rule does apply to financially settled contracts, all instruments that expire on the penultimate day should be excluded from any spot month limits.***

Options on the natural gas contract (specifically, the LN contract on NYMEX) expire the day prior to the underlying contract expiration, which places option expiration inside the time period where spot month limits are applicable. As currently proposed, the Proposal would aggregate option deltas and penultimate contract positions with last day positions for the application of position limits. Option deltas are not static and change based on a number of different factors, most significantly the price of the underlying contract and the time to expiration. As the options approach expiration, the deltas change very rapidly. In addition, the delta calculation can be viewed differently based on different models and model assumptions. The exchanges have recognized this in their current limit structure, and as such have exempted penultimate instruments, including options, from the spot month limits (*see*, *e.g.*, the LN, NP, HP, and QG contracts on NYMEX) for many years without incident. Subjecting options that expire on the penultimate day, to a hard limit structure would make managing an option portfolio virtually impossible and would result in a great deal of management, compliance, and enforcement confusion and uncertainty, and such limits would likely render the natural gas options market entirely untradeable. The natural gas market is the only one that we are aware of in which the options expire during the spot month limit window. We believe that the Commission should incorporate the approach that is currently used by the exchanges and not subject cash settled penultimate instruments to spot month limits.

5. ***The Commission should clarify that a conditional spot month limit for financially settled contracts (if limits are to apply to financially settled contracts) should not prohibit positions in the physically settled contract.***

Conditional spot month limits for financially settled contracts are disruptive to markets generally, and they become even more disruptive if they disallow the holding of physically settled contracts. We believe the best approach is one that encourages market participants to remain in the physically settled contract (which is vital to and used by commercial market participants for hedging purposes, and which sets the settlement reference price for the financially settled contract) without unduly restricting those same market participants from transacting in financially settled contract. Therefore, a market participant should be permitted to take a position in the physically settled contract up to the applicable limit, but that position should not prohibit the same market participant from taking an additional position in the financially settled contract. Instead, the trader must simply be required to count against its financially settled limit (if one is adopted and, for the reasons stated, we do not support one) the positon that it has in the physically settled contract.

That is, the higher limit must not be conditioned on the same trader holding no position in the physically settled contract. Conditional spot month limits that prohibit the holding of positions in the related physically settled contract, as set forth in the Proposal, without permitting risk to be allocated in an alternative way (for example, by entering into financially settled futures), impair the price discovery function of the market (i) at the time that it is most important, the spot month, and (ii) for market participants that rely on it most, commercials seeking to hedge commercial risk. This higher limit approach balances the benefits that deep liquidity brings to the financially settled contract (*i.e.*, smoothing volatility and limiting price swings) without the downside of those same traders abandoning the physically settled contract. Otherwise, as traders abandon the physically settled contract, it begins to lose viability as a hedging and risk management instrument as key liquidity is forced to exit during the spot month. Therefore, any final rule that includes a conditional limit for a financially settled contract must make clear that the conditional spot month limit for financially settled contracts does not prohibit positions in the physically settled contract.

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We appreciate the opportunity to provide these comments and we stand ready to provide any assistance in this process that might be helpful to the Commission.

Sincerely,

Greg Whalley

Greg Whalley
Copperwood Asset Management LP

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