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VIA ELECTRONIC FILING

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

Re: Re-Proposal of Proposed Rulemaking, Position Limits for Derivatives: RIN 3038-AD99

Dear Secretary Kirkpatrick:

The American Petroleum Institute (“API”), on behalf of its members, submits the following comments in response to the Commodity Futures Trading Commission (the “Commission” or “CFTC”)’s notice of a re-proposal of a proposed rulemaking establishing federal position limits for physical commodity derivatives (re-proposal). API commends the CFTC’s most recent efforts in issuing its re-proposal, which address some of the concerns raised by our members in prior comment letters, CFTC staff roundtables, and Advisory Committee meetings.

API is a national trade association representing more than 640 oil and natural gas companies. API’s members range from the largest major oil company to the smallest of independents. They are producers, refiners, suppliers, pipeline operators, and marine transporters, as well as service and supply companies that support all segments of the industry. The core business of API members is delivering affordable energy to their wholesale and retail consumers. Because their core businesses involve the purchase and sale of commodities, API members are among the most active end users of derivatives markets to fairly price their commodities and hedge their market, commercial and operational risks. API’s members, accordingly, have a keen interest in the protection and enhancement of derivatives market integrity and efficiency in order that those markets will ably serve their price discovery and hedging functions on which API members so heavily rely.

API shares the concern expressed by other parties that the proposed rule is not supported by the requisite necessity findings.¹ The Commission should not establish a new federal position limits regime for energy commodity derivatives until it is clearly demonstrated that such position limits are necessary to accomplish the objectives of the Commodity Exchange Act (“CEA”). API believes that the Commission has not fully evaluated and quantified the significant costs associated with its proposed position limits regime for energy commodities, especially those

¹ These include International Swaps and Derivatives Association, Inc., Futures Industry Association, Edison Electric Institute, and the Commercial Alliance.

direct costs and burdens related to reporting and compliance and the harm to market efficiency that will arise from reduced market liquidity if the rules are too burdensome. In this connection, the Commission should fully assess the possible adverse impact to the marketplace if the costs associated with the imposition of federal position limits cause some traders to vacate the markets thereby adversely affecting market liquidity and efficiency.

API members believe that the existing exchange-administered spot-month limit and position accountability regime for energy commodities continues to be quite effective in preserving market integrity and detecting and preventing any abusive trading, such that imposition of a costly and burdensome federal position limits structure simply is not warranted for energy commodities. Further, in view of the limited resources available to the Commission and the absence of a demonstrated need for changing the existing exchange-administered regime, API believes that the Commission's resources would be better deployed for tasks the exchanges cannot perform.

In view of the significance of this re-proposal to the marketplace, API strongly believes that the Commission should not take action on this rulemaking proceeding until a full Commission is confirmed by the U.S. Senate and has had an adequate opportunity to understand the substantive issues involved and the benefits and costs associated with the re-proposal. Only when a full slate of commissioners is in place should the Commission make a determination as to the necessity and appropriateness of a final speculative position limits rule.

Should the Commission ultimately move forward with a new federal position limit regime for energy commodities, API respectfully advocates that the Commission's final position limit rules should be guided by a policy that prioritizes enhancing and expanding the capacity of derivatives markets to provide commercial energy firms the means to hedge market, commercial, and operational risks to the greatest extent possible. Consistent with that goal, API strongly supports the Commission's decision to rely on the expertise of exchanges to recognize non-enumerated hedge exemptions ("NEBFH"), cross commodity hedge exemptions, and anticipatory hedging exemptions and encourages the Commission to affirm the substantial discretion exchanges may and should exercise in determining hedge exemptions from the limits. In addition, and consistent with market integrity and efficiency, API members believe it is vital that any reporting regime be simple and easily automated such that its benefits can be realized without introducing regulatory complexity, significant costs or unwarranted compliance risks that would discourage and inhibit market efficiency and use.

Position Limits Levels

The Commission's re-proposal would establish initial speculative position limit levels for the spot month as follows (in contracts): light sweet crude oil – 10,400; NY Harbor heating oil – 2,900; NY Harbor RBOB gasoline – 6,800; and Henry Hub natural gas – 2,000. The Commission stated that these levels were based on estimates of deliverable supplies as calculated by the exchanges or Commission staff. As noted above, API believes that, for energy commodities, the existing exchange-administered spot month position limit regime should be maintained in lieu of establishing an overly complex and unnecessary program of federally-mandated limits. Nevertheless, if the Commission decides to move forward with its re-proposal, API supports the Commission's determination to establish position limits based on estimates of deliverable supplies. Any new federal position limits, however, should allow the exchanges to operate as they do now and grant bona fide hedge exemptions up to the Commission's limits without causing any additional exchange or Commission reporting burden on market participants. We also believe the proposal for updating federal limits every two years based on updated estimates of deliverable supplies is reasonable.

With respect to single month and all month combined position limits, as noted, API believes that such limits are unnecessary, as the existing exchange-administered position accountability regime is sufficient to accomplish the purposes of the CEA.

Definition of Bona Fide Hedging – the “Economically Appropriate” Test

The re-proposal’s bona fide hedging definition under proposed Commission regulation 150.1 requires a bona fide hedge to be, among other things, “economically appropriate to the reduction of risk in the conduct and management of a commercial enterprise.” The economic test the Commission proposes for defining a bona fide hedge is too narrow because it limits bona fide hedges to only transactions that directly hedge price risk (i.e., transactions that hedge against changes in prevailing cash market prices on a roughly equivalent dollar-for-dollar basis) and excludes transactions that hedge other types of risks that are expressed in derivatives market prices but may correlate on a less than dollar-for-dollar basis. API respectfully submits that the limitation of the definition to price risk is an anachronistic vestige from a time of more limited market structures and products and much less sophisticated economic and risk tools and analytics. In addition, the re-proposal would effectively operate to substitute the discretion of individual commercial firms to manage their risk in accordance with their business objectives and judgment for a predetermined, government-mandated one-size-fits-all risk management framework. API, consistent with the views of many other commenters, strongly recommends that the Commission’s definition also include contracts, agreements and transactions that hedge operational, execution, logistics, location, and credit risks. Those risks are real risks, and API members in fact can and do use the derivatives markets to hedge them.

Derivatives markets’ prices are an expression and distillation of the participants’ collective expectations of many factors impacting supply and demand. Operational, execution, logistics (including the availability of transportation), location, and credit risks very clearly affect supply and demand and are expressed in market prices. API members use derivatives markets to hedge risks associated with production, quality, currency, interest rates, counterparty, credit, logistics, and other risks posed throughout their normal course of business. We accordingly suggest that the Commission’s definition is too rigid and out of step with the judgment and experience of commercial end users that need flexibility to manage the many risks incurred as part of their normal business activities.

Accordingly, API requests that the Commission’s “economically appropriate” test for bona fide hedges include contracts, agreements and transactions designed to hedge operational, execution, logistics, grade, location, and credit risks. If the Commission declines to broaden the scope of what is considered economically appropriate, API requests that the Commission then adopt a separate, distinct exemption category for those types of commercial risk management activities. A possible template for such a new exemption category could be the risk management exemption provision that is included in the Commission re-proposal for trades in excluded commodities (financial products). API understands that the Commission may view such an exemption as contrary to the intent of Congress to narrow the bona fide hedging definition. API notes, however, that Congress explicitly gave the Commission the authority to exempt any person, swap, contract, option, or transaction from position limits. See 7 U.S. Code § 6a(a)(7). API urges the Commission to utilize its statutory authority to establish such an exemption category to provide market participants the flexibility crucial to manage their day-to-day risks.

Enumerated Hedges – Anticipatory Hedges

API previously requested that the Commission expand the list of enumerated bona fide hedging categories to include all anticipatory hedges, especially anticipatory merchandising transactions. The Commission's re-proposal does not expand the exemption categories. The Commission stated its belief that such additional exemptions necessitate a consideration of the specific facts and circumstances on an individual case-by-case basis, but also noted that it would be "willing to explore further additions to the enumerated list at a later date." API encourages the Commission to further evaluate these issues and expand the bona fide hedging categories to include all types of anticipatory hedges. Like the existing categories of bona fide hedges, anticipatory hedges are a common need of commercial end users and are entered into regularly. They generally are neither complicated nor involve unique facts warranting case-by-case review.

Anticipatory merchandising hedges are crucial to risk management of commercial end-users and are statutorily recognized as bona fide hedges in CEA Section 4(a)(c)(2)(A)(iii). That Section 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.*" (Emphasis added) Merchandising activity transfers commodities into value or supply chains and ultimately brings them to consumers. Anticipatory merchandising hedges help both to offset price risk and to minimize price volatility. Limiting the ability of commercial firms to utilize these crucial risk management tools could result in increased price volatility and increased consumer prices. In addition, merchandising activity promotes convergence between cash and derivatives market prices. A reduction in the efficiency of convergence increases risk, reduces liquidity, and ultimately may lead to both higher consumer prices and lower producer prices. Allowing the full scope of hedging activity promotes the CEA's goals of efficient, effective and transparent markets.

The re-proposal specifies in proposed rule 150.11 that exchanges are authorized to grant exemptions of the following anticipatory hedges: unfilled anticipated requirements, unsold anticipated production, anticipated royalties, anticipated service contract payments or receipts, and anticipatory cross-commodity hedges. Under proposed rule 150.9, exchanges may grant exemptions for anticipated merchandising or anticipated purchase and storage as non-enumerated hedges subject to an assessment of the particular facts and circumstances. API supports these provisions, subject to the proviso that the Commission provides appropriate discretion and flexibility to the exchanges in administering the exemption process.

Enumerated Hedges – Unfixed Price Commitments

The Commission's re-proposal excludes from the definition of bona fide hedges derivatives transactions that hedge commercial commitments, such as locational basis contracts, that have some element of unfixed price. The Commission, however, correctly enumerated a calendar month spread as a bona fide hedge where it offsets unfixed priced cash purchases and sales. API continues to believe that all hedges related to unfixed price commitments should constitute bona fide hedges under the CEA. We recommend that the Commission determine that derivatives positions offsetting unfixed price cash commitments, such as locational basis contracts, be recognized as bona fide hedges. If the Commission declines to accept this recommendation, API requests that those types of commercial risk management activities be incorporated into a new and distinct risk management exemption category, as discussed above.

Exchange Authority to Grant Hedge Exemptions and the Commission Review Process

The Commission re-proposal grants the exchanges the authority to grant exemptions for non-enumerated bona fide hedge positions, certain specified enumerated anticipatory hedge positions, and spread positions. Under the re-proposal, the Commission would reserve the right to conduct a de novo review of exchange-granted exemptions “to maintain proper exchange oversight” and ensure that exchange actions are consistent with the bona fide hedge definition and Commission regulations.

API strongly supports the Commission’s delegation of authority to the exchanges to grant these types of exemptions. API recommends that the Commission expressly affirm that the exchanges are expected to exercise their authority flexibly and hospitably to support the hedging needs of market participants where a reasonable expectation of risk-mitigation exists. The expression of a “pro-hedging” policy would make clear that a primary objective in the exchanges’ exercise of exemption authority should be to support the hedging needs of market participants. That statement of policy would be salutary to eliminate any potential perception of Commission skepticism toward exchange-granted hedge exemptions. Such a statement of policy could instill confidence that, absent clearly unreasonable exercises of authority in granting exemptions, exchange determinations will be respected.

Consistent with the foregoing, API also believes the process for Commission review of exchange-granted exemptions needs tightening. First, the time period for any Commission review of an exchange exemption should be limited to 180 days from the time it is granted unless exigent circumstances require a longer time. The potential that an exchange granted exemption could be overturned creates undesirable market and legal uncertainty that can harm the recipient, as well as other market participants, irrespective of the merits. We believe the Commission has authority to limit the time for resolution in recognition of the need to minimize potential market disruption and harm.

Second, the final rules should provide that, in the event an exemption is reversed, the market participant will be allowed sufficient time to exit the position in an orderly fashion so as to not cause unintended harm to the markets or the recipient. Third, the Commission should make clear that where a market participant has relied on an exchange-granted exemption, no penalty would be assessed.

Finally, we recommend that the Commission’s rules recognize, at least for commercial end users, an exception to the position limits and the trader’s exemption limits in order to account for exigent circumstances that create an unforeseen or heightened level of risk. In such circumstances, a market participant may not be able to secure in a timely manner Commission or exchange permission to exceed a position or exemption limit before such market participant needs to increase its hedge position to offset the unforeseen or higher level of risk. For example, a commercial firm that uses New York Harbor for storage or blending of gasoline should be permitted to exceed its position or exemption limits without prior Commission or exchange approval, to the extent that is appropriate to hedge increased risks arising from a hurricane, such as Sandy, that hits the Eastern seaboard. In that example, the market participant that increased its derivatives position to a level that may be above its limit would not be subject to a penalty provided the firm acted in good faith and sought Commission or exchange review within a reasonable period of time.

Maintaining Hedges throughout the Spot Month – Elimination of the “Five-Day Rule”

The Commission’s “five-day rule” provides that hedge positions shall not be maintained during the expiry period (the last three to five trading days, depending on the commodity) of the spot month in an expiring contract. In response to comments received, the Commission’s re-proposal would allow the exchanges to grant spread and non-enumerated hedge exemptions throughout the spot month period, including the expiry days. API supports this proposal.

API, however, continues to urge the Commission to eliminate the five-day rule provisions from its regulatory definition of bona fide hedging. Such a restriction requires early liquidation of hedge positions, which can leave market participants exposed during the expiry period. It also frustrates market participants’ ability to either buy or sell the underlying physical commodity by taking or making delivery under the physical delivery futures contract. API notes that, in the energy futures markets, taking contracts to delivery is very common, especially in the refined products markets. In addition, allowing market participants to maintain their hedge positions during the expiry period could improve liquidity during that period, as forcing traders to exit their positions prematurely would reduce overall participation in the market during the expiry period. The Commission and the exchanges have effective surveillance programs and regulatory tools to adequately address trading during that period.

Reporting Costs and Burdens Associated with Completing Commission Forms

As previously noted, the reporting requirements for hedge positions should be simple and capable of easy automation. Overly complicated time-consuming and costly reporting will deter hedging, increase market participants’ commercial risk, and inhibit market liquidity.

Filing process. API recommends that for energy commodities the Commission clarify that its proposed reporting requirements apply only at such point that a participant’s position exceeds the Commission’s speculative position limit. In addition, at such time when the Commission position limit level is reached, the rules should permit such participant to file with the Commission only an identical copy of the form or reports required by the exchange on which the derivatives contract is traded.

Frequency of reporting. Exchange reporting requirements should be limited to quarterly filings. That frequency of reporting should adequately address the Commission’s desire to review for seasonal variations. The Commission has not demonstrated that there are regulatory benefits from more frequent filings that exceed the direct costs to market participants of more frequent filings and the increased costs to the marketplace if the increased costs prove to be a significant disincentive to market participation and hedging.

Proposed Form 204. Proposed Form 204 sets forth the data that must be provided by all reportable traders. As stated above, federal position limits for energy commodities are not needed or appropriate. However, if federal limits are imposed, API respectfully submits that expanding the scope of the current Form 204, which is limited to agricultural commodities, to include energy commodities is not necessary to fulfill the Commission’s oversight responsibilities and to monitor traders’ positions for possible position limit violations. Rather, for spot month exemptions, energy firms should be permitted to file with the Commission the same information that currently is filed with the exchanges. Further, with respect to single month and all months combined position limits, the Commission should make clear in the preamble to any final rules and the rules themselves that reporting will not be required until a market participant’s position exceeds the applicable position limit.

If the Commission decides to expand Form 204 reporting as proposed, however, the Commission should clarify the scope of the information required by Form 204. It is not clear whether it should include cross commodity hedges and grade/location specific information. API would oppose requiring reporting of grade/location specific information, as most firms maintain the relevant data on a portfolio basis that does not include that level of specificity. Compiling that information would entail significant costs and be of no discernable utility to Commission or exchange monitoring. In regard to the quantities reported, firms should be required to report data only with respect to the excess above the position limit. Also, the physical volumes required to be reported should be those reasonably related to the hedge position. Physical commitments unrelated to the hedge, such as, for example, volumes related to transactions in another region or country that have nothing to do with transactions being hedge in US derivatives markets, should not be reportable (e.g., Indonesian physical oil delivery commitments should not be reportable with respect to NYMEX oil futures hedges of inventory at Cushing). Finally the Form 204 instructions are not sufficiently clear as to how physical volumes that are not priced should be reported or valued.

Proposed Form 604. Proposed Form 604 would set forth the data to be reported by persons claiming a bona fide hedge exemption for either of two specific pass-through swap position types. The Commission should take into account the costs associated with compiling data for this report, which will be burdensome, especially for global firms which will likely require coordination among multiple systems throughout the world. In addition, proposed rule 19.01(b)(2)'s requirement that the Form be filed as of the close of business for each day the person exceeds the limit during the spot period and not later than 9 a.m. Eastern Time on the next business day following the date of the report is too short a time frame for many firms to collect and review the data for accuracy. Moreover, when a firm receives a special call for information at the same time it will be required to file reports, it could be exceedingly difficult to meet 24 hour timelines. The Commission's concern that a longer period for filing will impede surveillance necessary to prevent and deter manipulation can be better addressed by providing a longer time period for filing in the normal course, but authorizing Commission staff to require next day filing (with timely notice to filers) in circumstances where there is genuine concern that market conditions could invite manipulation. Further, where the Commission issues a special call for similar information to that otherwise to be provided in a report, relief from the filing deadline should be accorded.

Proposed Form 704. Proposed Form 704 would set forth the data to be reported by persons claiming a bona fide hedge exemption for certain anticipatory bona fide hedging positions. API recommends that the Commission make clear that a firm need not delay the execution of its hedge positions until the exemption is approved. Nor should a firm be required to assemble and provide three years historical data for a Form 704 initial statement. Among other reasons, data archived in discontinued systems may be difficult to access and three years of experience should not be determinative of the merits of an anticipatory hedge. The Commission recognizes the same by allowing persons with less than three years of data to submit initial statements.

Filing deadlines. The time periods for filing reports need to be increased. API believes that the time period allowed for filing a Form 204 – i.e., by 9 am Eastern on the third business day after the last Friday a month – is too short, especially for companies operating in multiple countries across multiple time zones. They will have difficulty assembling and reviewing for accuracy all of the necessary data for the relevant 24-hour period on the last Friday of the month. API recommends allowing five business days for filing Form 204s. We note that Form 40 requests in support of large trader reports generally allow a longer timeframe for responses. The next-day filing requirements for Forms 504, 604 and 704 also are too short a time frame for many

firms to collect and review the data for accuracy. Moreover, when a firm receives a special call for information at the same time it will be required to file reports, it could be exceedingly difficult to meet 24-hour deadline. The Commission's concern that a longer period for filing will impede surveillance necessary to prevent and deter manipulation can be better addressed by providing a longer time period for filing in the regular course, but authorizing Commission staff to require next day filing (with timely notice to filers) in circumstances where there is genuine concern that market conditions could invite manipulation. Further, where the Commission issues a special call for information similar to that which is also to be provided in a report, relief from the filing deadline should be accorded.

Form 604 also requires potentially onerous and time consuming research for a swap counterparty to claim the pass-through exemption. This may not be able to be accomplished within the proposed filing deadline for the Form 604. For example, pursuant to the swap pass-through exemption, a market participant (Counterparty A) entering into a swap with a Counterparty B that claims the trade as a bona fide hedge may claim the swap as a bona fide hedge, too, even though Counterparty A would not otherwise meet the requirements for the swap to be a bona fide hedge. This requires onerous and time consuming coordination between firms with very short deadlines, as Counterparty A in this example must obtain a written representation from Counterparty B that the swap qualifies as a bona fide hedge and then file a Form 604 if the trade caused Counterparty B to exceed its position limit. API recommends that the Commission rules grant five business days following execution of a swap to claim the pass-through exemption and file a Form 604.

Inadvertent errors. Finally, API recommends that there be a safe-harbor protection for inadvertent, negligent reporting errors. More extensive reporting obligations increase the potential for inadvertent errors and resulting technical enforcement. The Commission should reserve applying its enforcement powers only in the instance of knowing and bad faith reporting errors.

Recordkeeping Requirements

The re-proposal provides that any person claiming an exemption must maintain complete books and records concerning all details of their related cash, forward, futures, options and swap positions and transactions. It also provides that the Commission may request from any person with an exemption information relating to the positions owned or controlled, trading done pursuant to an exemption, the derivatives and cash market positions supporting an exemption and any relevant business relationships relating to an exemption.

API believes that the costs associated with these recordkeeping requirements are unnecessarily burdensome. We recommend that only the specific items needed by the Commission should be identified in this recordkeeping requirement and that those be limited to trading system records. Specifying that all details related to cash, forward, futures, options and swap position and transactions must be maintained is vague and overly broad. This provision could be read to cover virtually every piece of information (emails, whiteboards, scrap notes, etc.) in a firm's organization. In other words, this requirement could be read to effectively and unreasonably place an entire trading organization under a preservation order. API believes that the Commission should narrow the scope of the required records to be maintained to those specific categories that are necessary to determine compliance with position limits and any exemptions and conduct a comprehensive cost-benefit analysis comparing the benefits to be derived by the Commission to the costs imposed on the industry before adopting any final rule.

Implementation and Compliance Timeline

The Commission re-proposal states that the final rules would go into effect no earlier than January 3, 2018. API believes that a January 3, 2018 compliance date is unrealistic. In that regard, API believes that the Commission must allow sufficient time (1) for exchanges to develop new rules implementing the exchange exemption process, which may involve Commission review before they go into effect, and (2) for market participants to develop the necessary reporting and compliance mechanisms.

Consequently API recommends that the Commission set an effective date for any new rule as at least one year from the date that any exchange rules are finalized to comply with spot month speculative position limits. An implementation period of one year would be consistent with the time period adopted by the European Union for its position limits regime and is necessary for market participants to have sufficient time to implement and test firm-wide position-monitoring mechanisms, establish reporting and recordkeeping procedures, and develop compliance procedures. Specifically, commercial energy firms need time to create ways to automate the consolidation of data across transaction platforms for each of the required forms, and they need to create global frameworks to support the review and vetting of the data within the mandated timeframes. Also, since the re-proposal contemplates that certain matters are to be delegated to the exchanges, the exchanges will need time to update their rules, guidelines, and filing procedures, if necessary or desirable. Commercial energy firms will not be able to develop procedures to comply with their exemption requirements until after the exchanges adopt their rules.

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API appreciates the opportunity to provide these comments. API members are pleased to provide any additional information regarding their views and welcome the opportunity to work with the Commission on this rulemaking.

Should you have any questions or concerns regarding this comment, please direct them to Stephen Comstock at (202) 682-8455 or comstocks@api.org.

Sincerely,

/s/ Stephen Comstock
Director of Tax and Accounting Policy
American Petroleum Institute