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February 28, 2017

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

Re: *Position Limits for Derivatives*, RIN 3038-AD99

Dear Secretary Kirkpatrick:

On December 30, 2016, the Commodity Futures Trading Commission ("CFTC" or "the Commission") issued a Notice of Proposed Rulemaking regarding Position Limits for Derivatives ("Reproposed NOPR"),[1] which re-proposed regulations that were pending pursuant to an earlier proposal released by the Commission in 2013 and supplemented in 2016.[2] The Reproposed NOPR represents a further attempt by the Commission to create a comprehensive set of federal position limits rules and the latest step in a process that began in 2011.

The Coalition of Physical Energy Companies ("COPE") has consistently opposed the establishment of federal position limits rules on the grounds that: (1) there is no basis to conclude that commodity markets are at risk for the "excessive speculation" that the rule purports to address; (2) the proposed limits focus on concentration, not speculation, and as such do not address the very problem they are ostensibly aimed at; and (3) the Commission's proposals would impose unjustified burdens on physical companies that are their purported beneficiaries.[3] While, the

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

[2] *Position Limits for Derivatives*, 78 Fed. Reg. 75680 (Dec. 12, 2013); *Position Limits for Derivatives: Certain Exemptions and Guidance*, 81 Fed. Reg. 38458 (June 13, 2016).

[3] *See generally Comments of the Coalition of Physical Energy Companies*, RIN Nos. 3038-AD15, 3038-AD16 (Mar. 28, 2011) ("COPE Comments 2011"); *Comments of the Coalition of Physical Energy Companies*, RIN No. 3038-AD99 (Feb. 10, 2014); *Comments of the Coalition of Physical Energy Companies*, RIN No. 3038-AD99 (July 13, 2016).

Reproposed NOPR contains improvements over prior proposals, it does not overcome these core defects. Accordingly, COPE urges the Commission not to enact these federal position limits rules.

The members of COPE are physical energy companies in the business of producing, processing, and merchandizing energy commodities at retail and wholesale.[4] COPE members generally use swaps, futures, options, and trade options in conjunction with their physical businesses, most typically for hedging. As COPE understands the proposal, as physical commercial companies and hedgers in commodity markets, COPE members are among the intended beneficiaries of the proposed position limits regime.

**There Is No Market Driven Necessity For Federal Position Limits Rules**

The Reproposed NOPR describes the history of the Commission's federal position limits proposals since the passage of the Dodd-Frank Act beginning in 2011, with a particular focus on the process started in 2013.[5] The Reproposed NOPR parses statutory language and revisits studies and reports that, while not conclusive, at least "do no militate against and, to some degree, support the Commission's reproposal" of positions as a "prophylactic approach."[6] These are addressed in a legalistic manner with the Commission failing to find compelling reasons for a federal position limits rule and finding that, for example, the studies relied upon "do not dissuade the Commission from its consistent view that large speculative positions . . . pose risks to well-functioning commodities markets nor from its preliminary finding that speculative position limits are necessary to achieve their statutory purposes."[7] Nowhere does the Commission identify or assert there is a market driven necessity to impose federal position limits.

In contrast to the Commission's limited support for federal position limits and relative lack of empirical evidence of any need for such limits, on February 25, 2016, the CFTC Energy and Environmental Markets Advisory Committee ("EEMAC") issued a report that squarely addressed the merits of a federal position limits rule.[8] Many of the members of the EEMAC are engaged in physical energy businesses similar to those of COPE members. The EEMAC Report found, *inter alia*, in relevant part as follows:

> The Committee examined in detail whether adopting an entirely new regulatory regime for imposing position limits is necessary to prevent excessive speculation in energy derivatives markets, and the clear consensus was that it is not.

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[4] The members are: Apache Corporation; Avangrid Renewables, LLC; Kinder Morgan, Inc.; MarkWest Energy Partners, L.P.; Shell Energy North America (US), L.P.; SouthStar Energy Services LLC; and Targa Resources Partners LP.

[5] Reproposed NOPR at 96705-96716.

[6] *Id.* at 96726-27.

[7] *Id.* at 96727.

[8] *Report on EEMAC's 2015 Review and Consideration of the CFTC's Proposed Rule on Position Limits*, CFTC Energy and Environmental Markets Advisory Committee (EEMAC) (Feb. 25, 2016) ("EEMAC Report").

> In the February 2015 meeting, Professor Craig Pirrong presented an overview of the academic literature on the impact of speculation in commodity markets. He stated that although some studies purport to demonstrate an adverse impact from speculation, the execution of these studies, their interpretation, or both, fail to support these conclusions. To the contrary, the bulk of the economic literature fails to document any adverse impacts from speculation (Feb. 26 Tr. at 28-40).
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> At the same meeting, Energy Information Agency ("EIA") Administrator Adam Sieminski reviewed data produced by the EIA showing that the sharp decline in oil prices in 2014-2015 was not caused by speculation, but instead was the result of basic economic fundamentals: global supply has outpaced demand, leading to lower energy prices (Feb 26 Tr. at 21). This conclusion is similar to testimony of the CFTC's then-Chief Economist before committees in both Houses of Congress concluding that there was "little evidence that changes in speculative positions [were] systematically driving up crude oil prices" that peaked in July 2008.
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> Similarly, EEMAC participant Thomas LaSala, representing the CME Group, presented recent evidence demonstrating "no discernable impact" of swap dealer positions, managed money positions, or index positions on the price of West Texas Intermediate Crude Oil Futures (Feb. 26 Tr. at 70-75).
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> In addition, the EEMAC heard unrefuted evidence that energy derivatives markets are generally functioning well, particularly in the spot month. In fact, Eric Haas, representing the Intercontinental Exchange ("ICE"), presented evidence demonstrating that energy markets are exhibiting "model convergence," which ensures that they are venues for accurate price discovery and successful risk management (Feb. 26 Tr. at 68-70).
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> EEMAC meeting participants generally concurred in the view that as proposed, position limits are unnecessary because excessive speculation is not evident in the energy markets; as EEMAC member Michael Cosgrove noted:
>
>> Instead of being obvious, it is undetectable. If we claim that elephants were playing in the backyard then we would expect to see their footprints. The alleged excessive speculation, if it is taking place, is leaving no data footprints.[9]

COPE believes that the EEMAC Report got it right. We are not aware of any changes in commodity markets that have occurred since February 2016 that would now justify a federal position limits rule. The Reproposed NOPR does not identify any.

Further, in the experience of COPE members, the most material market change that has occurred since 2011 (when the Commission first took up this issue) is the "futurization" of swaps. Pursuant to such "futurization," energy derivatives have moved from mostly over-the-counter swaps to

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[9] *Id.* at 6-7 (internal citations removed).

exchange-traded futures. As futures, they have become subject to futures exchange-based position limits. Thus, the proportion of energy derivatives that are subject to position limits has substantially increased since 2011. This fact further supports the conclusion that there is no need for duplicative federal position limits.

It is COPE's view that there is no empirical justification for the federal position limits described in the Reproposed NOPR or its predecessor proposals. COPE members, as representatives of the group of commodity derivatives market participants that should benefit from and be protected by federal position limits, do not understand themselves to be the victims of excessive speculation or believe that the Reproposed NOPR will benefit them. Instead, as explained below, the architecture of the Reproposed NOPR will impose a significant administrative burden on physical end-users/hedgers without any discernable benefit to them.

Accordingly, the Commission should withdraw the Reproposed NOPR and decline to issue a final federal position limits rule.

**The Reproposed NOPR Would Impose A Burdensome and Duplicative Regulatory Regime on Commercial End-Users**

In its comments dating back to 2011, COPE has stated that the Commission's position limits proposals are likely the most burdensome on commercial end-users of all of the Commission's Dodd-Frank rules.[10] Similar to the proposals that preceded it, the Reproposed NOPR would institute a complicated duplicative position limits regime which would include both DCM position limits and federal position limits for the effectively same contracts and hedging activities.

Since the futurization of swaps commenced in 2012 through the actions of CME, ICE and other Commission-regulated futures exchanges, many commercial end-users have transitioned to a predominant reliance on futures for hedging. Those futures are subject to exchange position limits. To the degree such hedging requires a quantity of futures in excess of an exchange position limit, the end-user can seek a hedge exemption from the exchange or DCM[11] by demonstrating that its commercial risk requires hedging at a magnitude in excess of the applicable position limits. If justified, the DCM can grant a hedge exception effectively creating a higher position limit on the exchange. The commercial end-user then must prospectively manage its position to assure it does not exceed the relevant limits.

The Reproposed NOPR does not affect the DCM position limit process. Rather, it layers on an additional set of position limits and related processes for recognizing hedging in excess of position limits (enumerated bona fide hedges ["EBFH"] and non-enumerated bona fide hedges ["NEBFH"]) in a retrospective and transaction-specific manner (utilizing a particularly burdensome process), rather than a prospective and position-related manner. Thus, for end-users that use futures (subject to DCM position limits), their hedging activity will be simultaneously

[10] COPE Comments 2011 at 2, 5.

[11] Futures exchanges are regulated by the Commission under the Commodity Exchange Act as "designated contract markets" or "DCMs".

subject to two very different regulatory regimes imposing position limits for the same futures contracts and hedging. This duplicative structure is self-evidently burdensome and confusing.

Therefore:

- For DCM position limits, end-users will be required to manage their position such that they do not exceed the relevant position limit and, if they require a larger futures position to hedge their risk, they must seek a hedge exemption from the DCM which, if granted, will modify the limit prospectively.

- Under the Reproposed NOPR, the same end-user hedging the same risk will need to comply with a parallel position limits regime. In addition to obtaining a hedge exemption on a prospective basis, the end-user will, on a retrospective basis need to: (1) categorize and track each hedging transaction; (2) aggregate and track all cash transactions, production and stores across the affected enterprise; (3) create processes to file required forms to justify its EBFH's & NEBFH's; (4) collect data and prepare NEBFH filings (if EBFH's are inadequate); and (5) perform necessary administrative activities in support of the foregoing. As most commercial firms do not have in place systems and resources to perform these functions, significant new expenditures will likely be required.

COPE members are physical companies hedging risk that arises in the course of their physical businesses; they are not speculators, and are not engaged in core businesses that focus on derivatives trading. COPE believes that there is simply no justification for requiring commercial end-users to comply with two parallel regulatory requirements to address a problem which COPE does not believe exists. Even if there was a need for federal position limits, COPE does not believe that the imposition of this complex and burdensome scheme contained in the Reproposed NOPR would constitute reasoned decision making by the Commission to address this perceived problem. It certainly should not be imposed on physical hedgers who are using swaps and futures to mitigate, rather than seek out and benefit from, market risk. Even so, if the Reproposed NOPR is enacted as proposed, commercial end-users/hedgers will bear a disproportionate share of the burden.

Based upon the duplicative and burdensome nature of the proposed regime, the Commission should withdraw the Reproposed NOPR and decline to issue a final federal position limits rule.

**The Reproposed NOPR Contains Improvements But Largely Tracks Prior Proposals**

As noted above, the Reproposed NOPR contains the same burdensome duplicative architecture as prior proposals. It does include improvements that attempt to correct some of the most troubling aspects of the previous proposals. For example, the Reproposed NOPR contains higher position limits for commodities,[12] clears up years of confusion by explicitly eliminating trade options from the applicability of position limits,[13] and removes the "Incidental Test" and "Orderly Trading

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[12] Reproposed NOPR at 96720.

[13] *Id.* at 96735.

Requirement" from the definition of Bona Fide Hedge.[14] Nevertheless, the proposal continues to be overly complex and confusing.

Beyond the duplicative structure discussed above, the Reproposed NOPR:

- Imposes all month limits. The Reproposed NOPR would, for the first time, impose position limits for non-spot periods. COPE is not aware of any empirical basis for position limits to cover more than spot periods. COPE believes that if federal limits are enacted, the rule should include accountability levels rather than all month limits; currently, the exchanges have all month accountability levels, and this is a well-known and recognized method for tracking positions against the position limits. It has proven to be effective.

- Continues to rely upon specified EBFHs and NEBFHs as the mechanism to recognize legitimate hedging (rather than establishing a substantive definition of hedging as risk mitigation);

- Imposes the necessity for real-time tracking of EBFHs and NEBFHs and cash positions to accomplish the required burdensome recordkeeping and reporting;

- Includes a confusing and ambiguous process to create NEBFHs. COPE believes that the proposed delegation to DCMs is positive to the extent it provides a vehicle to obtain recognition of legitimate hedging activity that would otherwise not be considered "bona fide". However, the unclear process (and its potential impact on DCMs and their finite administrative resources) only adds more complexity to an already overly complex and burdensome proposal;

- Resurrects the confusing "one size fits all" forms required for claiming Bona Fide Hedge exemptions from prior proposals, again without meaningful instruction;

- Retains the Commission's prior proposed interpretation of the "economically appropriate test" for BFHs; and

- Retains the "Five-Day Rule" limiting the ability to hold positions in spot periods in excess of the relevant limits even if they qualify as Bona Fide Hedges.

While the Reproposed NOPR is technically a new proposal, in many ways it retreads the same ground as previous proposals for which reams of comments have been filed pointing out the flaws and potential harm to the market that would result from implementation. Rather than repeat its prior comments on elements that continue to be included in the reproposal, COPE refers the Commission to its previous comments, which address the points made above in more detail.[15]

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[14] *Id.* at 96743.

[15] *See supra* fn 3.

In addition, COPE notes that it agrees with the comments of others in this and prior proceedings that the Commission's proposed interpretation of the requirement that a bona fide hedge be "economically appropriate to the reduction of risk in the conduct and management of a commercial enterprise" is problematic. Specifically, the Commission has suggested it will interpret this test to require a company to consider all of its exposures in determining whether a derivative position reduces the risk of a commercial enterprise.[16] In effect, the Commission proposes a mandated analytical framework which requires risk management be considered at the level of the aggregated enterprise rather than at the level a commercial firm actually manages risk (such as the legal entity or asset level) or any other level. This focus on the aggregate, entity-wide risk effectively substitutes the judgement of the Commission for that of commercial enterprises themselves and is unrealistic and unworkable, particularly for large companies with multiple affiliates and joint ventures. COPE therefore requests that the Commission eliminate this concept of "economically appropriate" in any final rule.

Further, in the event the Commission chooses to enact a federal position limits rule, it should alter the proposal to remedy the foregoing issues. Any final rule should: include accountability levels rather than all-month limits; reduce the burden imposed on commercial end-users stemming from the backward-looking enumerated hedge regime embodied in the Reproposed NOPR; create user-friendly and clear forms and reporting processes; and eliminate the "Five-Day Rule."

**Conclusion**

For the foregoing reasons, COPE respectfully requests that the Commission not finalize federal position limits rules based on the Reproposed NOPR. In the event a final rule is issued, it should be revised to significantly reduce the burden on commercial end-users.

Respectfully Submitted,

/s/ David M. Perlman
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CC: COPE Members

[16] *See* Reproposed NOPR at 96746.