

BRACEWELL

May 15, 2020

VIA ONLINE SUBMISSION

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

Re: Comments on Position Limits for Derivatives Notice of Proposed Rulemaking [RIN 3038-AD99]

At its open meeting held on January 30, 2020, the Commodity Futures Trading Commission (“CFTC” or the “Commission”) approved a new proposed rulemaking concerning Position Limits for Derivatives (the “PL NOPR”).¹ The PL NOPR represents the most recent attempt by the CFTC since the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act² to implement a rule establishing federal position limits for futures and swaps.³

Since 2011, the Coalition of Physical Energy Companies (“COPE”) has been an active participant in the regulatory dialogue regarding the Commission’s efforts to create federal position limits.⁴ COPE has pointed out what it believed to be flaws in each of the prior iterations of the Commission’s position limits proposals and has recommended improvements and potential fixes to those flaws where appropriate. In particular, COPE has consistently taken issue with the redundancy of the Commission’s previous position limits proposals with the pre-existing exchange-based position limits rules and the burdensome impact of the Commission’s past proposals on those hedging the risks of a physical energy business.⁵ In contrast to the prior

¹ *Position Limits for Derivatives*, 85 Fed. Reg. 11596 (Feb. 27, 2020) (“PL NOPR or Proposal”).

² Pub. L. No. 111-203, 124 Stat. 1376 (2010) (“Dodd-Frank”).

³ 76 Fed. Reg. 4,752 (Jan. 26, 2011); 76 Fed. Reg. 71,626 (Nov. 18, 2011); 78 Fed. Reg. 75,680 (Dec. 12, 2013); 81 Fed. Reg. 38,458 (June 13, 2016); 81 Fed. Reg. 96,704 (Dec. 30, 2016).

⁴ See Comments of COPE, *Position Limits for Derivatives*, RIN Nos. 3038-AD15, AD-16 (filed Mar. 28, 2011) (“COPE 2011 PL NOPR Comments”); Comments of COPE, *Aggregation, Position Limits for Derivatives*, RIN No. 3038-AD82 (filed June 29, 2012); Comments of COPE, *Position Limits for Derivatives*, RIN No. 3038-AD99 (filed Feb. 10, 2014); Comments of COPE, *Position Limits for Derivatives*, RIN No. 3038-AD99 (filed Aug. 4, 2014); Comments of COPE, *Position Limits for Derivatives*, RIN No. 3038-AD99 (filed Mar. 30, 2015); Comments of COPE, *Position Limits for Derivatives*, RIN No. 3038-AD99 (filed July 13, 2016); Comments of COPE, *Position Limits for Derivatives*, RIN No. 3038-AD99 (filed Feb. 28, 2017) (“COPE 2016 PL NOPR Comments”).

⁵ See, e.g., COPE 2011 PL NOPR Comments at pp. 5, 10 (explaining that “[t]he increase in complexity” in moving from exchange-based limits to exchange and Federal limits would be “exponential” without any corresponding benefit

proposals, COPE believes that the PL NOPR presents a reasonable framework if the Commission believes that federal position limits must be imposed.

The members of COPE are physical energy companies in the business of producing, processing, transporting, storing, and/or marketing energy commodities at retail and wholesale. COPE members generally use swaps, futures, and other derivatives in conjunction with their physical businesses, most typically for hedging.

It is COPE's view that the PL NOPR represents an approach to the creation of federal position limits that captures the commodities specifically identified by the Commission as most in need of such oversight without creating a complicated and restrictive regime that is inconsistent with that already in place for designated contract markets ("DCMs"). In fact, the PL NOPR provides for an important role for DCMs which will permit the federal limits process to be enhanced by DCM expertise in the administration of exchange position limits. If carefully implemented—with close cooperation between the DCMs, the Commission, and market participants—COPE is optimistic that the position limits regime proposed in the PL NOPR can be effectuated without disruption to commodities markets. COPE urges the Commission to proceed in a deliberate manner to finalize the PL NOPR, taking into account market participants' comments and concerns, and avoid placing additional undue burdens on commodity markets. COPE is hopeful that the framework set forth in the PL NOPR can bring a successful conclusion to the Commission's decade-long position limits implementation efforts.

I. THE PL NOPR IS A REASONABLE APPROACH TO FEDERAL POSITION LIMITS

COPE believes the PL NOPR contains several positive attributes. Based upon its understanding of the PL NOPR, COPE makes the following observations:

- **The Proposed Limits are Reasonable:** The limits proposed in the PL NOPR are set at reasonable levels. Unlike exchange limits, they cover more than solely Core Referenced Futures Contracts but also include futures and options on futures linked to a Core Referenced Futures Contract and Economically Equivalent Swaps.⁶ Of course, the limits for the larger scope of contracts (many that are cash settled) should exceed the exchange limits that are for a single contract. In addition, as COPE understands it, the proposed limits are more aligned with deliverable supply than current exchange limits.⁷ Finally, the conditional limit for natural gas contracts, which allows market participants to hold up to 20,000 cash-settled positions, recognizes the limited positional effect on markets of cash settling contracts and permits a market participant to hold a larger amount of cash settling

to the market, and that the narrow proposed hedge exemptions would not capture all positions that would qualify for the end-user exception to the clearing requirement); *accord* COPE 2016 PL NOPR Comments at pp. 3-5.

⁶ See 85 Fed. Reg. at 11,598 ("Federal speculative position limits would apply to 'referenced contracts,' which include: (a) 25 'core referenced futures contracts;' (b) futures and options directly or indirectly linked to a core referenced futures contract; and (c) 'economically equivalent swaps.'").

⁷ See *id.* at 11,599 (proposing that spot month limit levels be set "at or below 25 percent of deliverable supply . . .").

contracts if it holds no physically settling contracts.⁸ This feature permits market liquidity in such contracts without sacrificing the benefits of position limits.

- The Scope of Covered Contracts is Appropriate: The PL NOPR extends to physically-settled Core Referenced Futures Contracts, futures and options on futures linked to a Core Referenced Futures Contract specifically listed by the Commission, and Economically Equivalent Swaps that contain materially identical terms to the Core Referenced Futures Contract. By limiting the covered “positions” to these contracts, COPE believes that the Commission has taken care to capture a reasonable group of contracts legitimately connected to the Core Referenced Futures Contracts. By providing a list of directly and indirectly linked futures and options on futures, and capturing only swaps with materially identical terms, the Commission has provided the requisite specificity for market participants to identify and track affected contracts.
- The Treatment of Netting to Determine Position Size Is Proper: The PL NOPR allows hedgers to calculate positions on either a gross or net basis as appropriate.⁹ As long as the hedger is following its policies and procedures for hedging, it may calculate its position on a net basis (except physically settling and financially settling contracts may not be netted). This approach permits the Commission to meet its regulatory goals while permitting hedgers to reflect the economic realities of their position.
- If Properly Implemented, The PL NOPR Will Not Impose an Undue Burden on Hedgers: Unlike prior proposals, the PL NOPR is not predicated on a complex federal regime that implements position limits in a form significantly different from DCMs. Importantly, it requires hedgers to track their positions to assure compliance instead of requiring the filing of forms with the Commission.¹⁰ Therefore, market participants will not be required to create a recordkeeping system¹¹ to capture and track data solely for the purpose of supporting the filing of forms with the Commission.¹² Under the federal position limits regime in the proposal, a market participant that already tracks its exchange position will need to add some additional contracts to its tracking effort. It will not be required to engage in a complex exercise to track cash market contracts, stocks, specific *bona fide hedges* and

⁸ See *id.* at 11,601 (summarizing the conditional spot month limit exemption in natural gas).

⁹ See *id.* at 11,678 (“The Commission proposes to permit market participants to net positions outside the spot month in linked physically-settled and cash-settled referenced contracts, but during the spot month market participants would not be able to net their positions in cash-settled referenced contracts against their positions in physically-settled referenced contracts.”).

¹⁰ See *id.* at 11,655; see also *id.* at 11,598 (The Commission believes that the proposal to eliminate Form 204 “will maintain the Commission’s access to information and result in a more efficient administrative process, in part by reducing duplication of efforts”).

¹¹ As set forth herein, COPE requests that the Commission clarify that market participants that are not CFTC or National Futures Association registrants not be made subject to a recordkeeping requirement beyond that which is necessary for their business and is typical for their industry. If that clarification is not made, it is likely that the PL NOPR may cause an undue burden on hedgers.

¹² See 85 Fed. Reg. at 11,655-56.

other information to support the filing of position limits forms with the CFTC. This feature of the Proposal is a very significant improvement over prior highly burdensome proposals.

- The Effectiveness of the Limits During the Spot Month is Proper: Consistent with exchange limits, federal position limits are proposed to be in effect only for the spot month.¹³ Currently, the spot month is the time when the exchange position limits are effective for the energy Core Referenced Futures Contracts. COPE believes that the exchange position limits requirements have been successfully implemented and are effective. Building on this success, the federal program should be complementary – not inconsistent with existing successful exchange position limits.
- Utilization of Exchange Expertise is an Important and Positive Feature of the Proposal: Under the existing exchange position limits process, a market participant that requires relief from exchange limits based upon its legitimate hedging needs can obtain a hedge exemption from the exchange. The market participant must file an application with all needed underlying data. Using this information, the exchange then evaluates whether a hedge exemption is needed to permit additional futures to mitigate the risks faced by the applicant. The PL NOPR delegates to the exchanges an evaluation of whether the hedging risks faced by an applicant are captured within the *bona fide* hedges established by the Commission.¹⁴ If not, the exchanges may recognize an additional *bona fide* hedge (subject to CFTC review).¹⁵ Existing exchange expertise from the hedge exemption process is well suited to this assignment. Further, exchanges should be able to process such requests more rapidly than a regulatory agency. The PL NOPR’s process for the exchanges to conduct this analysis, followed by Commission review permits an efficient and timely process for hedgers to obtain permission to mitigate their risk.

II. THE PROPOSAL SHOULD BE CLARIFIED TO REMOVE AMBIGUITY

In addition to the above observations, COPE believes the PL NOPR would benefit from some clarifications to create a clear regime that will best support market participant compliance. Some clarification components include:

- Physically Settling OTC Swaps: The Proposal refers to “physically-settling OTC swaps” in both the preamble and regulatory text.¹⁶ With the exception of a trade option or similar instrument, COPE understands that a swap is defined as a financially settling contract.¹⁷ Because the Commission has removed trade options from the scope of positions that would be

¹³ See *id.* at 11,599-600 (summarizing the federal position limits in and out of the spot month).

¹⁴ See *id.* at 11,649-52.

¹⁵ See *id.* at 11,651 (the proposal would allow a person to exceed position limits “if the exchange listing the contract has recognized the position as a *bona fide* hedge with respect to the exchange-set limits . . . unless the Commission denies or stays the application [for the *bona fide* hedge] . . . the exemption would be deemed approved for purposes of federal position limits”).

¹⁶ See *id.* at 11,636 n. 247 (“[T]here could potentially be physically-settled OTC swaps that would satisfy the ‘economically equivalent swap’ definition and therefore would also qualify as referenced contracts.”).

¹⁷ 7 U.S.C. § 1a(47).

subject to the limits,¹⁸ they are not the physically settling OTC swaps contemplated in the PL NOPR.

- COPE requests that the CFTC remove the concept of physically-settling OTC swaps from inclusion in the federal position limits regime or provide specific examples of the contracts intended to be included.
- Additional Bona Fide Hedges: An important aspect of the PL NOPR is a mechanism for exchanges and the CFTC to recognize *bona fide* hedges in addition to the list set forth in the PL NOPR.¹⁹ As COPE understands the Proposal, the existence of any such newly approved *bona fide* hedge would not be made public and it would only apply to the entity requesting its use.
 - COPE requests that any newly approved *bona fide* hedge be made public and added to the Appendix A list of enumerated *bona fide* hedges.²⁰ Of course, the appropriate factual predicate validating the legitimate hedging nature of the transaction should be included to assure market participants will properly apply it. By allowing newly identified *bona fide* hedges to be included in Appendix A on a real-time basis, the Commission will improve its regulatory program as it gains more experience with the federal position limits regime. Further, exchanges and the Commission will not have to repeatedly process requests to recognize the legitimacy of hedge strategy.
- Recordkeeping by Hedgers: The PL NOPR requires that any person relying upon a *bona fide* hedge exemption to exceed position limits:

shall keep and maintain complete books and records concerning all details of their related cash, forward, futures, options on futures, and swap positions and transactions, including anticipated requirements, production and royalties, contracts for services, cash commodity, products and by-products, cross-commodity hedges, and records of bona fide hedging swap counterparties, and shall make such books and records available to the Commission upon request . . .²¹

From the perspective of COPE members, regardless of the commodity involved in their business, physical energy companies keep detailed records in the normal course of business as required therefor. They are not CFTC-regulated companies and are not subject to direct CFTC or National Futures Association oversight. Therefore, they do not keep records in a fashion that slots into the terminology used in the PL NOPR. Rather, they keep relevant business records associated with their business in a manner consistent with common practices and requirements for such a business.

¹⁸ See *id.* at 11,621 (“The Commission has traditionally exempted trade options . . . because they are typically used by end-users to hedge physical risk and thus do not contribute to excessive speculation.”).

¹⁹ See *id.* at 11,651.

²⁰ See *id.* at 11,637 (noting that Appendix A enumerates the currently recognized bona fide hedges); see also *id.* at 11,726-27 (Appendix A).

²¹ *Id.* at 11,722.

While these records will likely capture the information that is of interest to the Commission, they are not kept as described in the PL NOPR, and they do not necessarily contain “all details.”

- COPE requests that the Commission clarify that the recordkeeping requirements for hedgers is limited to the normal business recordkeeping as is customary for their business and industry. Such records should be sufficient to validate the *bona fide* hedging nature of a position. Compliance with the language of the regulatory text would be burdensome and confusing for a non-CFTC regulated businesses, as their business records are not kept in a manner that comports with the CFTC’s derivatives regulation focus.
- The “Unfilled” Language of Enumerated Hedge 10 Should Be Clarified: Enumerated Hedge 10 recognizes the *bona fide* hedge status of long positions in commodity derivative contracts for hedging unfilled anticipated cash commodity for processing and manufacturing.²² Physical energy companies may enter into physical fuel agreements for power production for security of supply that are priced at an unfixed spot index price. The price risk of such contracts is often hedged with a long position in commodity derivative contracts.
 - Enumerated Hedge 10 uses the term “unfilled anticipated requirements.” If the physical power plant fuel requirements were purchased on the spot market at the prevailing price, Enumerated Hedge 10 would clearly apply. There is no material difference between a physical security of supply contract at spot index price and real time purchases a prevailing spot prices. However, it is unclear whether such a contract would meet the “unfilled” element of Enumerated Hedge 10. The Commission should clarify that Enumerated Hedge 10 applies to such hedging price risk physical spot index fuel supply contracts.

III. CONCLUSION

COPE generally supports the Proposal, subject to the clarifications described above because the Proposal reasonably balances the goals of Dodd-Frank with the realities of the market. Accordingly, COPE respectfully requests that the Commission work to timely finalize the Proposal, taking into account COPE’s suggested clarifications.

²² See *id.* at 11,727:

(10) *Hedges of unfilled anticipated requirements.* Long positions in commodity derivative contracts that do not exceed in quantity the person’s unfilled anticipated requirements for the contract’s underlying cash commodity, for processing, manufacturing, or use by that person, or for resale by a utility as it pertains to the utility’s obligations to meet the unfilled anticipated demand of its customers for the customer’s use.

Respectfully submitted,

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cc: COPE Members