May 15, 2020

Submitted Electronically

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

Re: Position Limits for Derivatives (RIN 3038-AD99)

Dear Mr. Kirkpatrick,

AQR Capital Management, LLC ("AQR" or "we")[1] appreciates the opportunity to provide comments to the U.S. Commodity Futures Trading Commission (the "Commission" or "CFTC") on its proposed amendments to regulations concerning speculative position limits (the "Proposal").[2] We believe that the Proposal represents a thoughtful and refined approach to a complex issue and encourage the Commission to adopt final rules consistent with the proposed framework.

The Commission has worked tirelessly through a number of years and multiple proposals to fulfill its statutory mandate to establish position limits where it finds that they are ''necessary'' for the purpose of ''diminishing, eliminating, or preventing'' ''[e]xcessive speculation…causing sudden or unreasonable fluctuations or unwarranted changes in…price…."[3] As active participants in the futures markets we share the Commission's goal of ensuring that excessive speculation does not lead to negative impacts on pricing and have a strong interest in the Commission's efforts to implement a new position limits regime. We have engaged with the Commission on this topic for a number of years,[4] and based on our experiences in the futures markets and evaluation of past Commission position limits initiatives we believe that the Proposal is the most effective attempt to address this issue. The Proposal

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[1] AQR is registered with the U.S. Securities and Exchange Commission as an investment adviser under the Investment Advisers Act of 1940 and as a commodity pool operator and a commodity trading advisor with the Commodity Futures Trading Commission under the Commodity Exchange Act. As of March 31, 2020, AQR and its affiliates had approximately $143 billion in assets under management.

[2] Position Limits for Derivatives, 85 Fed. Reg. 11596 (Feb. 27, 2020) ("Position Limits Proposal").

[3] Dodd-Frank Act, 7 U.S.C. 6a(a)(1).

[4] *See, e.g.*, Letter from Brendan Kalb, Managing Director and General Counsel, AQR Capital Management, LLC, to Christopher Kirkpatrick, Secretary, CFTC (Feb. 29, 2017), *available at* file://aqrcapital.com/users/grantr/Downloads/61120BrendanKalb%20(3).pdf ("2017 AQR Letter").

appropriately balances the Commission's goal of preventing excessive speculation and the manipulation of commodity prices with the needs of producers, hedgers, and speculators to access well-functioning, liquid markets.

In furtherance of our support for the broad contours of the Proposal, we would like to highlight three key elements of the rulemaking that are critical to implementing an effective federal position limits regime:

1. Focusing primarily on spot month limits for most referenced contracts rather than extending limits to non-spot months;

2. Setting proposed position limit levels using updated deliverable supply data and revising the formula for non-spot month limits; and

3. Developing an appropriately tailored definition of economically equivalent swaps.

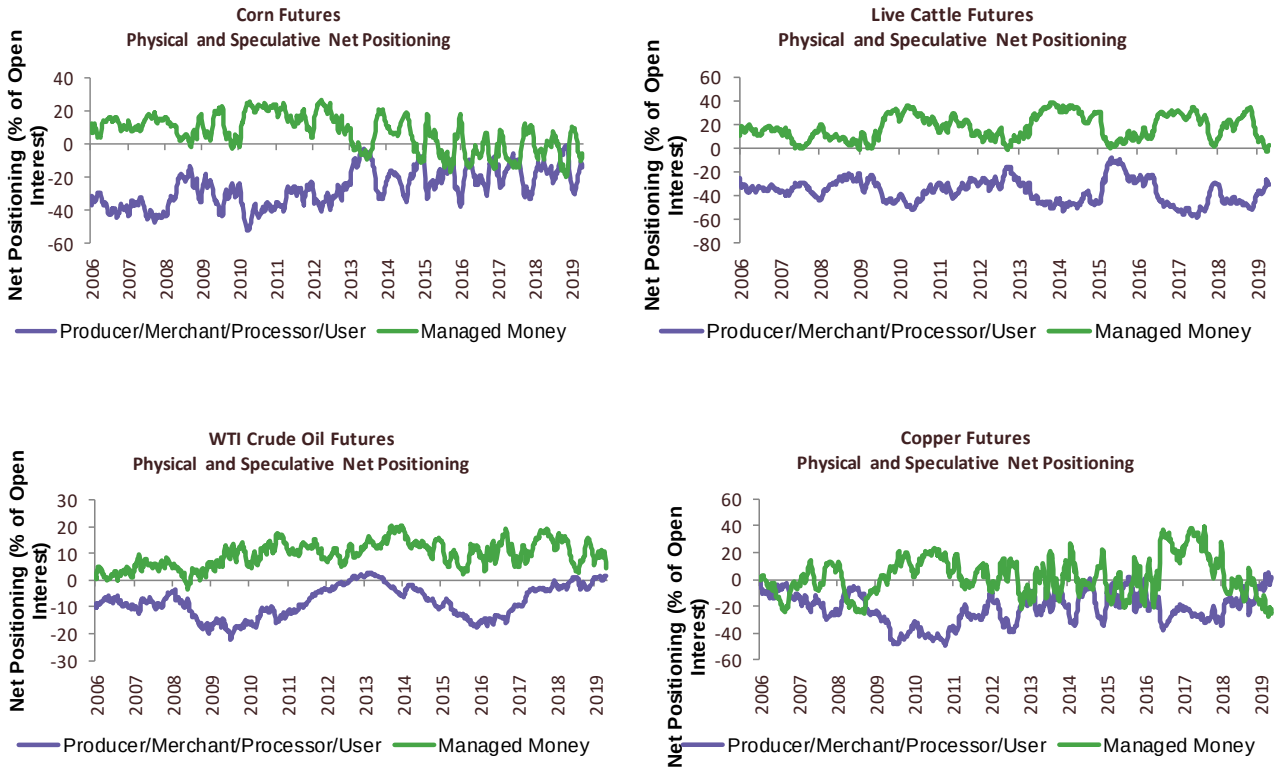
Each of these components is critical to ensuring that any federal position limits adopted by the Commission effectively address potential concerns about market manipulation and price squeezes without inadvertently harming the liquidity and orderly functioning of the commodity futures markets.

I. Nature of the Commodity Futures Markets

Before discussing specific aspects of the Proposal we believe it is important to reiterate the important roles that various participants play in the commodity futures markets. For example, in many commodity markets, commodity producers and consumers have for decades hedged their physical commodity exposure by entering futures positions. This requires other market participants (*e.g.*, speculators) to take offsetting positions. Within this market dynamic AQR and other sources of managed money play a vital role by assuming price risk from commercial participants (*i.e.*, hedgers) on the long and short sides of the market, and providing the liquidity that facilitates risk transfer for businesses around the world. Any regulation that decreases the ability of speculators to assume price risk from commercial participants will ultimately increase the cost of hedging and impair market liquidity.

The symbiotic relationship between hedgers and speculators can be seen through data from the CFTC's disaggregated Commitments of Traders Reports from 2006 to 2019. As shown in Figure 1 below, the "Producer/Merchant/Processor/User" category has tended to take a net short position, while the "Managed Money" category tends to take an offsetting long position. As the net positions of the Producer/Merchant/Processor/User category change over time they tend to be offset by changes in the Managed Money category.

Figure 1: Comparison of Physical and Speculative Commodity Futures Trading[5]



Given this dynamic, the ability of producers and other commercial hedgers to meet their needs in the commodity futures markets at a reasonable cost is inextricably linked to the ability of managed money to provide sizable liquidity in the market. Maintaining a lower cost for commercial participants hedging throughout the futures curve necessarily requires more market participants seeking to take offsetting positions in size. Thus the imposition of position limits that reduce the ability of the existing managed money participants to take these positions will directly result in a higher cost for hedgers due to reduced market liquidity and the need for those engaging in the market to earn a higher premium for taking an offsetting position.

The Proposal must be analyzed not just within the context of the common hedger and speculator relationship that is a hallmark of the commodity markets, but also as it interacts with unrelated market dynamics leading to increased consolidation throughout the money management industry. This consolidation is occurring due to the benefits of scale as investors shift to lower fee offerings such as passive and factor-based investment strategies. As this consolidation continues, more of the "managed

[5] Source: Commitments of Traders (COT) Reports, using "Disaggregated Futures Only," *available at* www.cftc.gov/MarketReports/CommitmentsofTraders/index.htm.

money" category will be made up of large managers. Within this construct it will become increasingly difficult for the money management industry to provide sufficient liquidity to producers and commercial hedgers if the Commission imposes restrictive position limits on those large managers.

While we recognize and appreciate the Commission's mandate to impose position limits in order to prevent market manipulation and associated negative pricing impacts, we believe that it is also important that any final position limit rules acknowledge the legitimate needs of market participants on both sides of each trade and not overly restrict managers in ways that would be harmful to the markets as a whole.

II. Spot Month Limits

The most important aspect of the Proposal is the Commission's determination to focus federal position limits for most referenced contracts on the spot month, rather than also extending limits to non-spot months. The spot month is where the physical and futures markets converge, and is thus where the potential for abuse – by way of a corner or squeeze – presents the most risk of disruption to the physical markets. To the extent the Commission determines that position limits are necessary to address negative pricing impacts caused by excessive speculation, limits in the spot month are the appropriate avenue for attending to those concerns.

A. The spot month is where manipulation could theoretically occur

As active market participants we depend on competitive, transparent, well-functioning markets to execute our investment strategies. Given this dependence we support the Commission's efforts to prevent manipulation in the commodity futures markets. Although market manipulation could arise through a variety of means, the primary way that manipulative actions could distort commodity prices is where there is an asymmetry between the ability to take delivery and the ability to deliver a physical commodity. For example, this situation could arise where a participant holds a large long position relative to deliverable supply and attempts to take that position to delivery. This could make it difficult for holders of short positions to either exit their contracts or source physical commodity for delivery, leading to market panic and distorted prices in the underlying physical commodity.

The key to this type of potential manipulation, however, is that it cannot be effectuated until the financial and physical markets converge as a commodity contract moves towards delivery (*i.e.*, into the spot month). As a result, the spot month is the most critical period for price discovery and distribution of the underlying commodity, and an appropriate area of focus for the Commission.

In addition to the spot month's importance to price discovery, the Commission's focus on this time period is justified because the pricing of commodity futures contracts is particularly sensitive as those contracts move towards the actual delivery date. As a contract moves closer to delivery, the number of active market participants decreases, as does correspondent liquidity in the product. This decrease occurs because any participants active at that time must be able to either take physical delivery of the commodity or move in and out of positions within a very short period of time. Many market

participants – whether corporate hedgers, producers, or managed money – are not willing or able to assume this particular risk and thus prefer to maintain desired exposures by always rolling their contracts well before delivery. The combination of fewer market participants and less liquidity during an important period of price discovery suggests a time frame when prices may be particularly sensitive to manipulation and a potential opportunity for manipulators to transact in ways that could distort market prices.

The sensitive liquidity and price dynamics in the spot month are highlighted by recent market developments in the WTI Crude Oil futures contract, which saw dramatic changes in price and open interest during the final days of trading in the May 2020 contract. The May 2020 WTI Crude Oil futures contract fell from $18.27 (per barrel) to -$37.63 on April 20, 2020, the penultimate day of trading in the contract, before settling at $10.01 on April 21, 2020, the last day of trading.

Figure 2: Open Interest for May 2020 WTI Crude Oil Futures Contract[6]

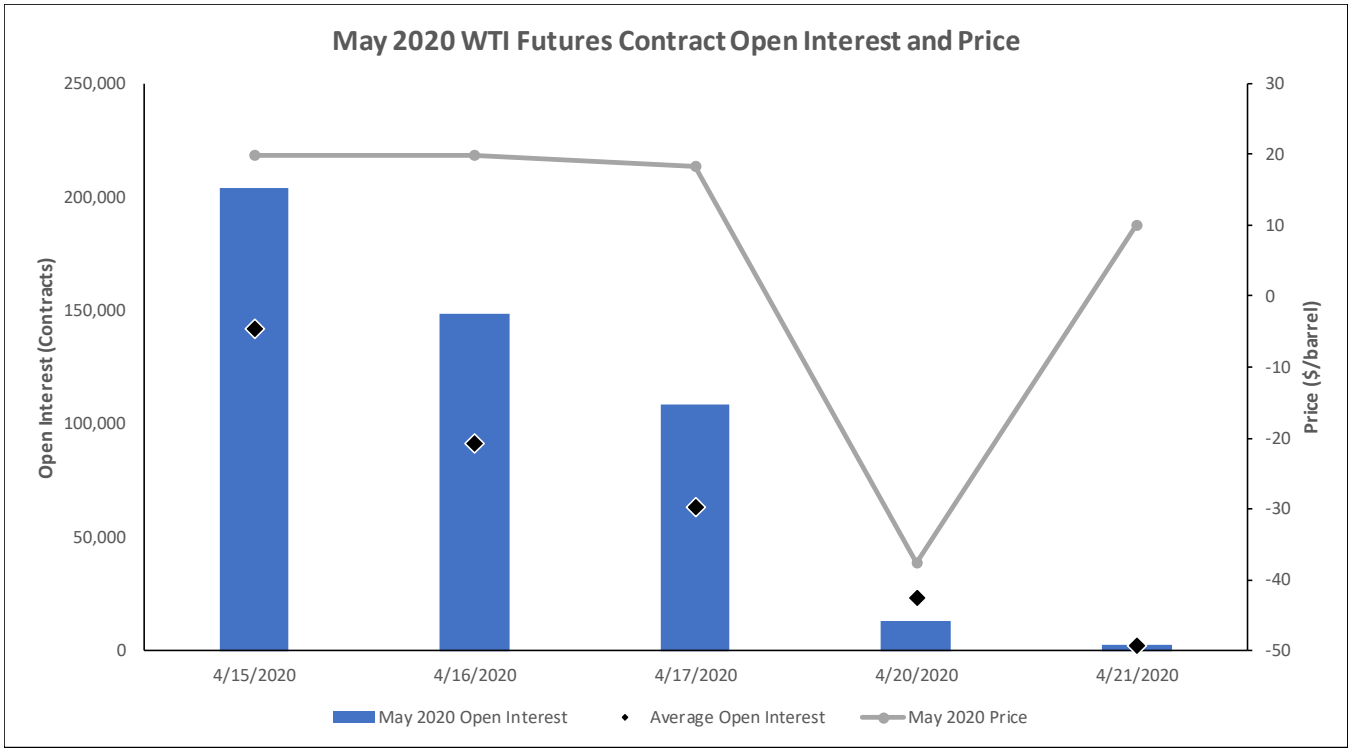


Figure 2 above depicts changes in the open interest and price of the WTI Crude Oil futures contract during the last five days of trading. The left axis of Figure 2 shows the open interest of the WTI Crude Oil futures contract, with blue bars representing the May 2020 WTI Crude Oil futures contract open interest and black diamonds representing the average open interest of the 120 monthly WTI Crude Oil futures contracts for the previous ten years. This data reveals that the open interest in the May 2020

[6] Source: Bloomberg.

WTI Crude Oil futures contract was well above average leading into the final days to expiration, including on Friday, April 17, 2020, one trading day before the price drop. However, at the close of trading on April 20, 2020, the day of the price drop, the open interest had declined to a level significantly below the average. While it is normal for the open interest in a commodity futures contract to drop substantially during the spot month period, the change in the May 2020 WTI Crude Oil futures contract was much greater than usual. The open interest at the beginning of April 20, 2020 was higher than all WTI Crude Oil futures contracts with two days left of trading in the previous ten years. The open interest at the end of April 20, 2020 was lower than all WTI Crude Oil futures contracts with one day left of trading in the previous ten years.

While it is not entirely clear what led to the steep decline in price and open interest for the May 2020 WTI Crude Oil futures contract on April 20, 2020, movement in calendar spreads and open interest suggest that a large number of long contracts needed to be rolled or exited while short contracts may have been intending to hold to delivery.[7] These dynamics occurred against a backdrop of increasingly tight storage capacity (and therefore capacity to take delivery) at the delivery point for the contract. Although the magnitude of changes in price and open interest during this period was unusual, it is not surprising that these large moves happened specifically in the spot month, when the market transitions from a large number of contracts that are not held to delivery to the much smaller number of contracts that are taken to delivery.

We are not aware of (and do not suggest) any manipulative activities surrounding these recent events, but rather offer them as an example of the greater sensitivities of commodity pricing as contracts move towards delivery. To the extent the Commission determines that position limits are necessary for any contracts to prevent potential manipulation, it is during this period that those limits might be warranted. At the same time, we note that the dramatic changes in the May 2020 WTI Crude Oil futures contract occurred during the "spot period" when restrictive spot month limits already exist for this contract at the exchange. This fact suggests that while position limits may prevent potential manipulative activity by restricting the ability of market participants to hold concentrated positions during the spot period, they are not an appropriate tool for preventing price movements caused by underlying market and delivery dynamics.

The inability of position limits themselves to eliminate the unpredictability of commodity futures markets highlights the importance of existing Commission and exchange oversight of these markets and the dangers of overreliance on a single regulatory tool to address market dynamics for which it may not have been designed. Spot month position limits in the WTI Crude Oil futures contract could in fact have prevented large speculators from entering the market to balance out the volatile price movements in the May 2020 WTI Crude Oil futures contract. As a result, when determining whether to impose federal position limits we encourage the Commission to consider not only concerns around potential

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[7] The price difference between the June 2020 and the May 2020 WTI Crude Oil futures contracts increased from $6.76 (per barrel) to $58.06 on April 20, 2020. In addition, while open interest in the May contract dropped by 95,539 contracts on April 20, 2020, open interest in the June contract increased by 43,598 contracts. Both of these moves are consistent with market participants selling out of the May contract and buying the June contract (*i.e.*, rolling their positions). The fact that the reduction in open interest in May was larger than the increase in June suggests that a number of market participants sold out of their May contracts without buying the June contract.

manipulation, but also the potential unintended consequences of such limits and the need for liquidity during sensitive time periods for commodity futures markets.

B. Non-spot month limits are not needed

We do not believe that non-spot month activity raises the same concerns around manipulation and/or price disruption as those in the spot month. Thus, we strongly support the Commission's determination to not apply federal position limits to non-spot month contracts for the majority of referenced contracts.

The Commission accurately and succinctly identified the justification for not imposing non-spot month limits in the Proposal, stating that "…corners and squeezes cannot occur outside the spot month when there is no threat of delivery, and there are tools other than federal position limits for deterring and preventing manipulation outside of the spot month."[8] A noted above, the primary path toward manipulation of a commodity price runs through the convergence of the physical and financial markets at delivery. This type of manipulation simply cannot occur in non-spot months. More broadly, manipulation through the accumulation of large positions in non-spot months is unlikely given two primary controls: market dynamics and existing oversight.

The first reason that manipulation is not likely to occur through the accumulation of non-spot month contracts is that market participants have sufficient time to incorporate trading information for those contracts before they move into the sensitive pricing period around delivery. While trading decreases as the spot month contract moves toward physical delivery, leaving fewer participants to digest and react to pricing information during a compressed time frame, trading in the outer months is analyzed by the entire market and all market participants have the time, ability, and incentive to incorporate that information into their trading and thereby balance out any unusual trading or position accumulation.

A second reason why position limits in non-spot months are not necessary is that existing oversight at both the Commission and exchanges already properly regulates these activities. As noted in the Proposal, "[s]urveillance at both the exchange and federal level, coupled with exchange-set limits and/or accountability, would continue to offer strong deterrence and protection against manipulation outside of the spot month."[9]

Accountability levels are particularly effective in managing trading in non-spot months. They allow exchanges to identify the accumulation of large positions, engage in a dialogue with market participants about those positions, and force them to be reduced as needed. Given the lack of immediate impact that trading in these contracts has on the physical price of commodities, the exchange accountability level process provides sufficient regulatory oversight to address concerns about excessive speculation. Even extremely large positions held during this period would not impact physical

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[8] Position Limits Proposal at 11629.

[9] *Id.*

commodity prices and exchanges have the tools to prevent positions that could potentially be used to distort prices in the physical market from being maintained into the spot month.

In addition to these arguments for why federal position limits in non-spot months are not necessary, we are also not aware of any empirical evidence indicating or suggesting that non-spot month trading has led to price squeezes or distorted pricing in the underlying commodity. Even the theoretical argument that the accumulation of extraordinarily large long positions in a nearby month could lead to the perception of a nearby shortage of a commodity lacks empirical support and does not seem compelling given that market participants are constantly analyzing and incorporating market information and such an attempt at price distortion would likely be unsuccessful given competitive market dynamics.

For these reasons we support the Commission's decision to impose position limits for most referenced contracts in the spot month only.

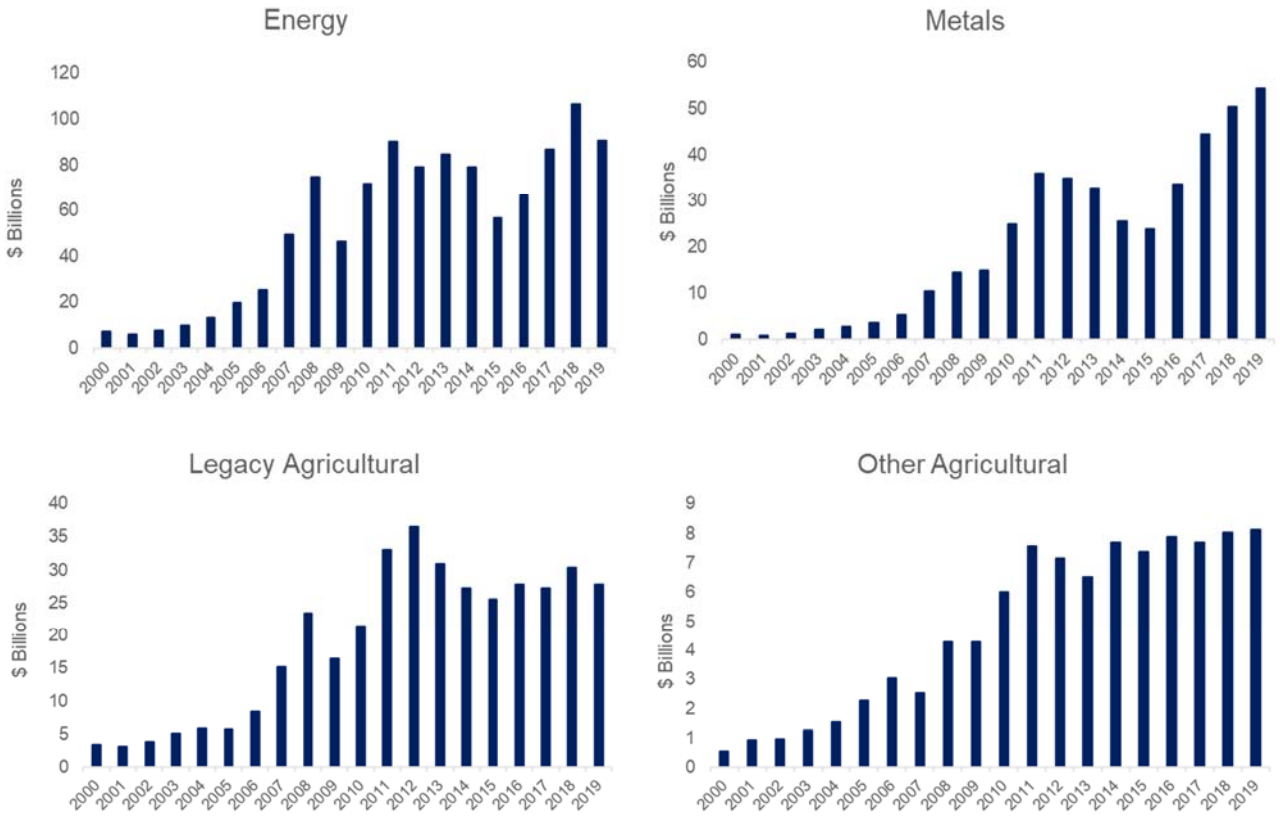
III. Data-driven approach to position limits

We also support the Commission's use of updated deliverable supply data and a revised formula for non-spot limits in setting the levels of the proposed position limits.

The Commission's data-driven approach to setting new position limits results in limit levels that appropriately reflect current activity in the commodity futures markets and the relative size of position accumulation that would be necessary to engage in manipulative activity. The use of updated data is important given the overall growth these markets have seen over the past two decades as highlighted by Figure 3 below, which shows the average daily volume (in USD notional exposure) for each sector.[10]

[10] For purposes of Figure 3, daily volume is summed across contracts to get the sector level volume, then averaged across days in the year to get the annual average.

Figure 3: Growth in Commodity Futures Trading Volumes[11]



This steady growth in volumes traded in these contracts significantly reduces the market impact of holding and trading large positions. Increased volumes also suggest that the ability of any individual to manipulate the price of a commodity would be greatly reduced when compared to 15 or 20 years ago because market manipulation generally requires the accumulation of positions of such large size that they impact the ability of other market participants to meet their contract obligations in the normal course. This type of manipulative activity becomes increasingly more difficult as markets grow and thus the increased volumes seen in Figure 3 and the increased open interest data used by the Commission justify higher position limit thresholds than previously proposed by the Commission.

These increased limits and revised formula are particularly important for legacy agricultural contracts with non-spot limits. Liquidity provision in these contracts is already constrained by non-spot limits, but market participants are able to maintain liquid markets in these products by utilizing swaps,

[11] Source: Bloomberg. The "Energy" chart includes: NG, CL, HO, and RB. The "Metals" chart includes: GC, SI, HG, PL, and PA. The "Legacy Agricultural" chart includes: C, O, S, SM, SO, W, KW, and CT. The "Other Agricultural" chart includes: LC, RR, CC, KC, OJ, and SB.

as needed. The Commission's finding that it is statutorily obligated to extend limits to swaps – combined with both spot and non-spot limits for legacy agricultural products – could have severely negative market impacts if the spot and non-spot limits for these products are not increased as proposed.

IV. Economically Equivalent Swaps

Despite the concerns we have previously noted to the Commission that subjecting swaps to position limits is not necessary to prevent market manipulation,[12] we recognize that the Commission has determined that it is statutorily obligated to extend limits to swaps.[13] Given this determination, we believe that the Commission has effectively tailored the definition of economically equivalent swaps – and related application of position limits – in a way that fulfills its statutory obligation without unnecessarily harming market liquidity.

One of the most important aspects of extending position limits to swaps is the ability of market participants to obtain a clear understanding of whether their swaps are subject to the limits. This is no easy task in the over-the-counter swaps market where many transactions are highly bespoke. Applying broadly written definitions concerning which swaps are subject to limits would be incredibly onerous from a compliance perspective and could have a chilling effect on market liquidity.

The Commission thoughtfully avoided many of the potential problems that could arise with extending position limits to swaps by proposing a definition for economically equivalent swaps that is clearly defined and appropriately tailored. The Proposal defines an "economically equivalent swap" as one that has identical material contractual specifications, terms, and conditions to a referenced contract.[14] Terms that are considered material for these purposes include underlying commodity, maturity or termination dates, and settlement type (*e.g.*, cash- versus physically-settled).[15]

We support this definition and agree with the Commission's statement in the Proposal that it most appropriately "…focus[es] federal limits on those swaps that pose the greatest threat for facilitating corners and squeezes – that is, those swaps with similar delivery dates and identical material economic terms to futures and options on futures subject to federal limits – while also minimizing market impact and liquidity for bona fide hedgers by not unnecessarily subjecting other swaps to the new federal framework."[16]

The opportunity or ability to use a swap to squeeze or corner an underlying physical commodity is extremely remote and thus extension of position limits to swaps would likely not be merited based on an analysis of the costs and benefits of such action. However, given the statutory obligation under which the Commission has indicated that it operates, we believe that focusing on only those swaps that

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[12] *See* 2017 AQR Letter at 12.

[13] *See* Position Limits Proposal at 11597.

[14] *Id.* at 11615.

[15] *Id.* at 11616.

[16] *Id.* at 11615-16.

are designed to specifically replicate a referenced contract subject to federal position limits is the most appropriate outcome.

The Commission's focus on swaps with identical material contractual specifications, terms, and conditions as referenced contracts, and clear guidance that settlement type is one of these material terms, is particularly important for liquidity in legacy agricultural contracts with non-spot month limits. Market participants have historically relied on the swaps market to maintain sufficient liquidity in these commodities where the pre-existing non-spot limits constrain the ability of speculative investors to meet the liquidity demands of hedgers. Even with the raised spot and non-spot limits for these commodities incorporated in the Proposal, market participants may from time-to-time need to access swaps to ensure sufficient market liquidity. Focusing the swaps definition on swaps that have identical material terms to referenced contracts and thus pose the greatest threat for manipulation – while at the same time not subjecting other swaps to federal position limits – is a key aspect of the Proposal that will help maintain properly functioning markets for these commodities.

Were the Commission to not provide this type of flexibility it could not only lead to reduced liquidity for bona fide hedgers, but also drive market participants to seek liquidity in foreign jurisdictions.[17] While many in the managed money community have the capabilities to obtain commodity exposures abroad, we expect that many producers and commercial hedgers in the U.S. would not. We commend the Commission for acknowledging this reality in global financial markets and seeking to implement an extension of position limits to swaps that does not drive participants into foreign jurisdictions to the detriment of U.S. market liquidity.

Any extension of position limits to swaps risks negatively impacting commercial hedgers by reducing market liquidity, increasing transaction costs, and increasing commodity market volatility. While the Commission cannot entirely avoid those risks if compelled to impose such limits, the proposed approach to economically equivalent swaps may mitigate them in ways that allow the Commission to fully discharge its statutory obligation without unnecessarily restricting market activity.

V. Conclusion

We commend the Commission and its staff for their work on this Proposal, which reflects a thoughtful approach to an extremely complex issue. As active participants in these markets we have a vested interest in seeing them regulated properly and at the same time not unnecessarily restricted. We support the Proposal as a balanced approach that will continue the Commission's strong oversight of commodity futures markets without imposing unnecessary barriers to liquidity provision that could ultimately harm market participants and the U.S. markets themselves.

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[17] We note that Section 4a(a)(2)(C) of the Commodity Exchange Act requires the Commission to strive to ensure that any position limits imposed by the Commission will not cause price discovery in a commodity subject to federal limits to shift to trading on a foreign exchange. *See* Position Limits Proposal at 11615.

Thank you for your consideration of these comments. Please feel free to contact us at Ari.Levine@aqr.com or Richard.Grant@aqr.com with any questions.

Sincerely,

/s/ Ari Levine

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Portfolio Manager

/s/ Richard Grant

Richard Grant
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