May 15, 2020

By Electronic Submission

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

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

Ladies and gentlemen,

Better Markets, Inc. ("Better Markets")[1] appreciates the opportunity to comment on the Commodity Futures Trading Commission's ("CFTC") proposed rulemaking establishing a substantially revised position limits framework[2] intended to implement statutory mandates in section 4a of the Commodity Exchange Act ("CEA"),[3] as amended by section 737 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act").[4]

Better Markets has for almost a decade called on the CFTC to lawfully implement a meaningful speculative position limits framework for derivatives (futures, options on futures, and swaps) referencing physical commodities. Although we are supportive of the CFTC's attention to public interest concerns relating to speculative position limits and their effects on the pricing, integrity, and utility of the derivatives markets on physical commodities, the newest proposal only further delays the CFTC's now decade-long rulemaking process[5] by (1) deferring too significantly to exchanges to establish, administer, and monitor

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[1] Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system, one that protects and promotes Americans' jobs, savings, retirements, and more.

[2] CFTC, Position Limits for Derivatives, 85 Fed. Reg. 11596 (Feb. 27, 2020), available at https://www.govinfo.gov/content/pkg/FR-2020-02-27/pdf/2020-02320.pdf.

[3] 7 U.S.C. § 6a. The CEA is codified at 7 U.S.C. § 1 et seq.

[4] Section 737, Pub. L. 111–203, 124 Stat. 1376, 1722-25 (2010).

[5] This is the CFTC's fifth recent proposal establishing position limits for physical commodities, in addition to multiple final regulations and related proposals. See, e.g., CFTC, Position Limits for Derivatives, 76 Fed. Reg. 4752 (proposed Jan. 26, 2011); CFTC, Position Limits for Futures and Swaps, 76 Fed. Reg. 71,626 (Nov. 18, 2011), vacated by Int'l Swaps & Derivatives Ass'n v. U.S. Commodity Futures Trading Comm'n, 887 F. Supp. 2d 259 (D.D.C. 2012); CFTC, Position Limits for Derivatives, 78 Fed. Reg. 75,680 (proposed Dec. 12, 2013) (withdrawn); CFTC, Position Limits for Derivatives: Certain Exemptions and

position limits pursuant to minimal and often non-binding guidance; and (2) opening too many avenues to avoid, if not evade, meaningful federal and exchange-determined position limits through expanded exemptions and delegations of authorities.[6] For these reasons, among others, any final rulemaking adopted as a logical outgrowth of the CFTC's proposal would, at best, obscure the lack of meaningful limits on speculation.

There are elements of the CFTC's proposal that have merit and some would represent significant progress in implementing a federal position limits framework. However, the CFTC's fifth proposal in ten years continues to suffer from significant legal and policy deficiencies that must be remedied before finalization.

The proposal's five most material deficiencies are as follows:

1. **The federal spot month limits for derivatives on the 25 physical commodities subject to the most critical elements of the proposal would generally represent significant increases in permissible speculation.**

   The proposal would dramatically increase federal position limits for all of the legacy agricultural contracts and establish new federal position limits that greatly exceed most exchange-set limits for derivatives on the other physical commodities subject to the most critical elements of the proposal. The proposal would, however, establish federal spot month position limits on futures contracts on 25 core physical commodities ("Core Referenced Futures Contracts"),[7] as well as linked cash-settled futures and options contracts and economically equivalent swaps (collectively, "Referenced Contracts").

Guidance, 81 Fed. Reg. 38,458 (June 13, 2016) (withdrawn); CFTC, Position Limits for Derivatives, 81 Fed. Reg. 96,704 (proposed Dec. 30, 2016) (withdrawn).

[6] In this comment letter, we use the term "exchange" to include designated contract markets ('DCMs"), the traditional exchanges authorized to facilitate trading in futures contracts, certain options, and swaps, as well as swap execution facilities ("SEFs"), multilateral electronic trading platforms or systems created by the Dodd-Frank Act to facilitate trading solely in swaps and to promote pre- and post-trade transparency in the swaps markets. DCMs are governed by the CEA section 5 and part 38 of the CFTC's regulations, which implements the 23 statutory DCM core principles. See 7 U.S.C. § 7. DCM core principle 5 governs DCM rules for position limitations and accountability and requires merely that DCMs set position limits at levels that are no higher than applicable federal limits and adopt for "each contract . . . as is necessary and appropriate, position limitations or position accountability for speculators." 7 U.S.C. § 7(d)(5)(A). SEFs are governed by CEA section 5h and part 37 of the CFTC's regulations, which implements the 15 statutory SEF core principles. See 7 U.S.C. § 7b–3. SEF core principle 6 governs SEF rules for position limits or accountability and requires that SEFs set position limits at levels that are no higher than applicable federal limits, adopt for "each of the contracts of the facility . . . as is necessary and appropriate, position limitations or position accountability for speculators," and monitor positions established on or through the SEF for compliance with federal and SEF position limits, if any. 7 U.S.C. § 7b–3(f)(6). Although SEFs have these position limits responsibilities under the SEF core principles, the CFTC observes that "most economically equivalent [commodity] swaps that would be subject to federal position limits [would be] expected to be traded OTC and not executed on SEFs." CFTC, Position Limits for Derivatives, 85 Fed. Reg. 11596, 11652 (Feb. 27, 2020). For that reason, most of our comments are focused on the position limits responsibilities of DCMs listing the core physically settled futures contracts.

[7] The 25 Core Referenced Futures Contracts subject to certain federal position limits would be as follows: (1) the Chicago Board of Trade ("CBOT") Corn, (2) CBOT Oats, (3) CBOT Soybeans, (4) CBOT Soybean Meal, (5) CBOT Soybean Oil, (6) CBOT Wheat, (7) CBOT KC Hard Red Winter Wheat, (8) the Minneapolis Grain Exchange ("MGEX") Hard Red Spring Wheat, (9) ICE Futures U.S. ("ICE") Cotton No. 2, (10) the Chicago Mercantile Exchange ("CME") Live Cattle, (11) CBOT Rough Rice, (12) ICE Cocoa, (13) ICE Coffee C, (14) ICE FCOJ-A, (15) ICE US Sugar No. 11, (16) ICE Sugar No. 16, (17) the Commodity Exchange ("COMEX") Gold, (18) COMEX Silver, (19) COMEX Copper, (20) the New York Mercantile Exchange ("NYMEX") Platinum, (21) NYMEX Palladium, (22) NYMEX Henry Hub Natural Gas, (23) NYMEX Light Sweet Crude Oil, (24) NYMEX New York Harbor ULSD Heating Oil, and (25) NYMEX New York Harbor RBOB Gasoline. Nine of these contracts are already subject to federal position limits. The proposal expands the scope of the position limits framework to seven new agricultural contracts, five new metals contracts, and four new energy contracts.

2. **The proposal would not establish federal position limits for non-spot-month derivatives contracts on 16 of the 24 physical commodities subject to the most critical elements of the proposal**.

   Federal position limits for derivatives on nine agricultural commodities[8] have been implemented for decades for single months beyond the spot month and all-months combined. Although the proposal expands the reach of federal spot month position limits to derivatives on additional types of agricultural, energy, and metals commodities, the proposal would not apply federal (non-spot-month) single-month and all-months-combined position limits in 16 of the 25 Core Referenced Futures Contracts.

   Furthermore, a proposed default formula that would be used by exchanges to calculate non-spot single-month and all-months-combined position limits would be considerably more permissive than the current formula used by the major DCMs. The new formula would establish non-spot-month limits at 10 percent of open interest for the first 50,000 contracts (rather than the first 25,000 contracts), with incremental increases of 2.5 percent of open interest above the proposed tier-one threshold.

3. **The proposal would dramatically expand (almost triple) the number of self-effectuating enumerated exemptions and for the first time, recognize a broad exemption (read, loophole) for anticipatory merchandizing.**

   The proposal would implement numerous expansive and self-effectuating "hedging" exemptions from position limits, including multiple new exemptions for anticipatory merchandizing and other anticipatory trading strategies supposedly in the nature of "bona fide hedging transactions or positions." As a consequence, the proposal would exclude an unknown percentage of total positions from the federal and exchange limits framework and in a manner that all but eliminates meaningful constraints on speculation in derivatives markets on key physical commodities. This is because the self-effectuating enumerated hedging exemptions may treat speculative trading positions as "bona fide hedging transactions or positions" for purposes of federal and exchange position limits.

4. **The proposal would implement a new process for recognizing non-enumerated hedging strategies that practically eliminates CFTC oversight.**

   The proposal would permit exchanges to grant non-enumerated bona fide hedging exemptions for purposes of federal and exchange position limits. The CFTC's oversight of exchange determinations with respect to such hedging exemptions would be limited by the impractically short review periods for exchange-approved hedges. Although the proposal would provide authority for the CFTC (and not its staff) to stay and/or object to such determinations, the proposed review process would risk reducing the CFTC's supervisory role to mere notice on the most complex hedging applications.

5. **The proposal would make necessity findings and interpret ambiguities in CEA section 4a as requiring such a finding before finalizing any position limits on derivatives on physical**

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[8] See 7 U.S.C. § 1a (including in the agricultural contracts definition CBOT Corn (and Mini-Corn) (C), CBOT Oats (O), CBOT Soybeans (and Mini-Soybeans) (S), CBOT Wheat (and Mini- Wheat) (W), CBOT Soybean Oil (SO), CBOT Soybean Meal (SM), MGEX Hard Red Spring Wheat (MWE), CBOT KC Hard Red Winter Wheat (KW), and ICE Cotton No. 2 (CT). See also 17 C.F.R. § 150.2.

commodities, raising unnecessary administrative hurdles and opening avenues for legal challenges to meaningful position limits.

The proposal includes a preliminary determination that the CFTC must make an antecedent "necessity" finding that establishing federal position limits is "necessary" for each of the 25 Core Referenced Futures Contracts. The CFTC's factors in determining as much are reasonable in a number of respects. However, the CFTC includes a lengthy legal analysis that reverses the CFTC and CFTC staff's longstanding legal views that the ambiguities in CEA section 4a, *if any*, should be construed, in light of agency expertise, to require position limits on derivatives on physical commodities.

The legal analysis and broad factors provided in the proposal are unlikely to limit the CFTC's practical ability to impose federal position limits. Nevertheless, the legal analysis contravenes a better reading of CEA section 4a's statutory commands and congressional intent (including the reading articulated in the CFTC's 2016 Position Limits Proposal). The "necessity" findings also unnecessarily raise administrative hurdles and open avenues for legal challenges to the CFTC's position limits framework.

For the above reasons, others discussed below, and still others not addressed in the proposal at all (e.g., the sudden or unreasonable fluctuations or unwarranted changes in the price of physical commodities caused by excessive speculation through exchange-traded funds ("ETFs"), commodity index funds, and similar speculative vehicles), we are unable to support the CFTC's position limits proposal. We acknowledge positive elements of the proposed position limits framework. For example, it would implement federal spot month position limits that would account for linked contracts and most economically equivalent swaps. It would impose constraints on derivatives speculation in 16 new agricultural, energy, and metals commodities. And it would eliminate the risk management exemption from position limits, which is long overdue. These, of course, are welcome developments relative to the complete lack of a position limits framework applicable to derivatives on most physical commodities. **Yet, under the CFTC's newest proposal, the potential for implementation of federal position limits that do not actually limit speculation remains too great**.

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I. The April oil futures trading anomalies are only the most recent demonstration of the sudden or unreasonable fluctuations or unwarranted changes in the price of physical commodities caused by excessive speculation.

Four weeks ago, the May (then spot month) oil futures contract for West Texas Intermediate ("WTI") grade crude oil[9] fell more than $50 per barrel and closed below $0, at -$37.63, on a single full trading day before expiration.[10] The most precipitous drop in the contract price occurred in a period of less than 25 minutes, with a relatively small number of contracts as a percentage of total trading day volume initially trading at negative prices.[11] The May WTI contract price rallied to +$.01 by 8:03pm the same

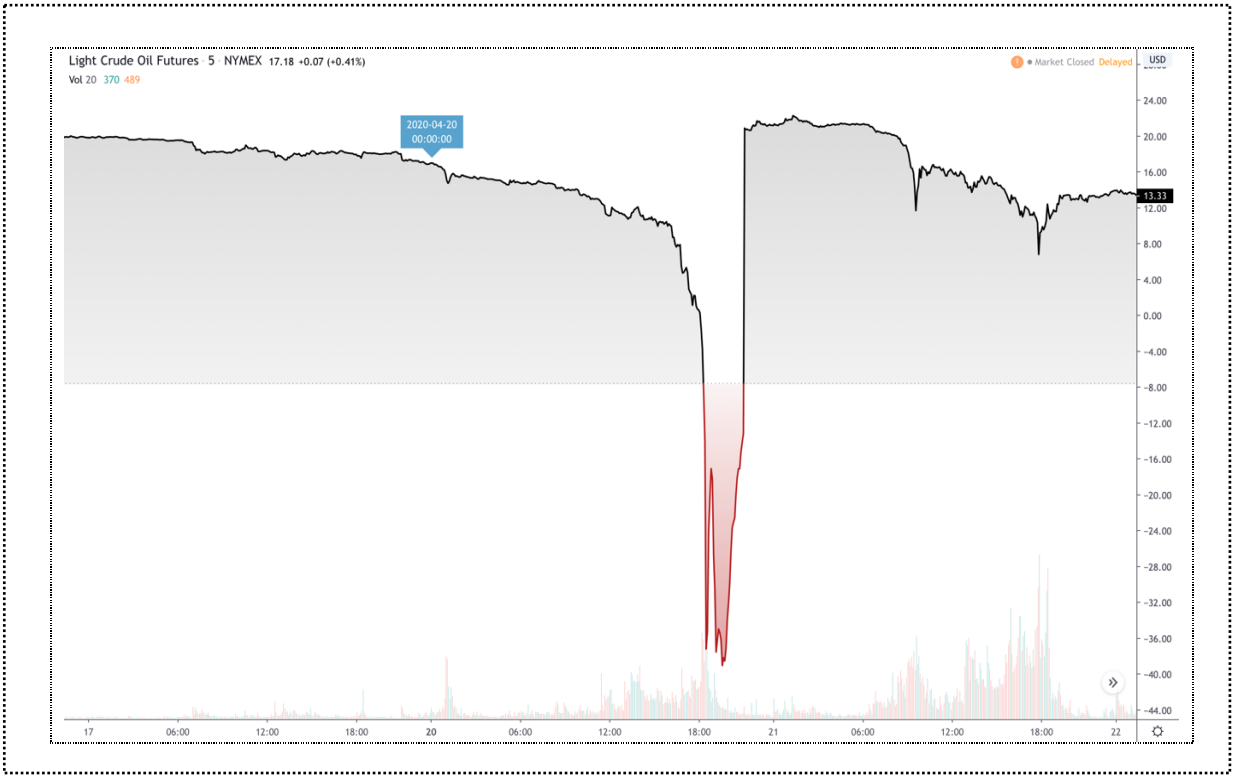
[9] The spot month WTI futures contract is considered a benchmark contract for the pricing of oil. West Texas Intermediate (WTI) is a grade of crude oil often described as "light" because of its relatively low density and "sweet" because of its low sulfur content. It is the underlying commodity of the New York Mercantile Exchange's ("NYMEX") most critical crude oil futures contract.

[10] See CME Group, Crude Oil Futures Settlements, available at https://www.cmegroup.com/trading/energy/crude-oil/light-sweet-crude_quotes_settlements_futures.html#tradeDate=04%2F20%2F2020. For additional information on settlements in the CME's WTI futures contract, see also WSJ Markets, Commodities, available at https://www.wsj.com/market-data/commodities. According to the U.S. Energy Information Administration ("EIA"), the Cushing, Oklahoma WTI spot price hit a low of -$36.98 on Monday, April 20, 2020 before recovering to +$8.91 the next day. For spot price data on WTI physicals, see EIA, Petroleum & Other Liquids, Cushing, Oklahoma WTI Spot Price FOB (Dollars per Barrel), available at https://www.eia.gov/dnav/pet/hist/rwtcD.htm.

[11] The WTI May contract closed at approximately $18.27 the previous trading day, Friday, April 17, 2020. The contract dropped to $0 by 2:08pm the following trading day and then proceeded into a precipitous decline to -$37.63 by the CME's daily settlement at 2:30pm 22 minutes later. See I. Bouchouev, Negative oil prices put spotlight on investors, Risk.net (Apr. 30, 2020), available at https://www.risk.net/investing/7536946/negative-oil-prices-put-spotlight-on-investors ("One thing is for sure, while Covid-19 has caused an unprecedented oil demand shock, it does not account for the 300% drop in the price of US benchmark

calendar day (post-trading session).[12] Meanwhile, during the Monday trading session, the June WTI contract remained above $20, closing at a record spread to the May WTI spot month with a puzzling differential of more than $55 as of the trading session close.[13]

WTI Crude Oil Futures Contract (May Spot Month)



Source: NYMEX WTI Contract (May)[14]

The next trading day (the final trading day), the May WTI contract recovered, traded at record volumes, and settled at +$10.01, another dramatic one-day price swing in the spot month contract of more than $47 from the previous day's close.[15] Other near-term contracts along the WTI futures curve remained substantially positive as well, albeit in decline. The June WTI futures contract, for example, experienced a

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crude on April 20, much of which took place in just 20 minutes."). As expiry of the May spot month contract approached on Monday, April 20, 2020, the WTI contract dropped from more than 600,000 contracts in open interest to approximately 108,593 contracts in open interest. Yet, the volume weighted average price on that trading day was approximately $8. Id.

[12] For one particular take on the events of April 20, 2020, see A. Root, This is Why Oil Turned Negative, and Why It Will Be at $20 on Tuesday (Apr. 20, 2020), available at https://www.barrons.com/articles/kkr-stock-earnings-loss-assets-investment-firm-private-equity-51588800580.

[13] The closing price on the June WTI contract on April 20, 2020 was $20.43. See CME, Crude Oil Futures, Globex, (Jun 2020), available at https://www.cmegroup.com/trading/energy/crude-oil/light-sweet-crude.html.

[14] See WSJ Markets, Commodities, available at https://www.wsj.com/market-data/quotes/futures/CL1/advanced-chart.

[15] See S. DiSavino, Brent oil futures plunge as growing glut feeds market panic (Apr. 20, 2020), available at https://www.reuters.com/article/us-global-oil/brent-oil-futures-plunge-as-growing-glut-feeds-market-panic-idUSKBN22230I.

more than 40% price decline but settled at +$11.57 on the final day of the contract before, again, swinging another 19% the next day.[16]

To be sure, the supply and demand fundamentals of the oil markets in the lead-up to these two trading days played *a role* in the settlement week anomalies. For example, the considerable volatility in oil prices and the negative prices in spot month contracts undoubtedly reflected, in part, a combination of diminished demand arising from the recent COVID-19-related economic slowdown (with more than 26 million new unemployment claims as of the end of that week from March 15th[17]) and continued relative overproduction of oil that could not be economically stored at the WTI May contract's delivery points. In the latter regard, limited storage capacity in Cushing, Oklahoma and increasingly scarce available storage undoubtedly made it costly to take delivery and store oil for eventual resale.[18] For these reasons, expectations relating to supply and demand fundamentals of the oil markets ***contributed*** to the oil the futures markets trading environment.

However, the story does not stop there. There was not much new about the economic environment in the last two trading days for the May contract. The physical market fundamentals did not change in dramatic fashion on Monday alone, or in 25 minutes on Monday alone, only to slingshot back more than $40 into positive territory the next trading day. Nor would or could physical markets producers and consumers of crude oil adjust commercial activities in response to anomalous price changes on a 25-minute intraday timeline.[19] **That was a function of speculative trading activities and expectations reflected in order flows and other factors within the *financial markets,* not activities with respect to underlying *commodities markets*.** Indeed, if the negative prices experienced in the WTI May contract solely reflected supply and demand factors and diminishing storage capacity in Cushing, Oklahoma, then the price almost certainly could not have rocketed back to settle at +$10.01 the very next day, much less created the super contango futures curve and unprecedented spread between the May spot month and most near-term expiries.

Thus, the prominence of the role of supply and demand fundamentals in April's trading anomalies is debatable,[20] but it is absolutely **certain** that a number of traders with a significant market presence were

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16 CME Group, Crude Oil Futures, Globex, (June 2020), available at https://www.cmegroup.com/trading/energy/crude-oil/light-sweet-crude_quotes_globex.html.

17 See Federal Reserve Bank of St. Louis, FRED Economic Data, Initial Claims, U.S. Employment and Training Administration (accessed May 15, 2020), available at https://fred.stlouisfed.org/series/ICSA.

18 Capacity utilization in Cushing, Oklahoma was reportedly as high as 81% as of April 24, 2020. The EIA estimates that physical inventories "increased by 24.9 million barrels (69%) from March 13 to April 24." EIA, U.S. crude oil inventories are approaching record-high levels (Apr. 30, 2020), available at https://www.eia.gov/todayinenergy/detail.php?id=43555.

19 The oil markets, like other critical commodities markets, are not efficient enough to adjust to momentary changes in prices in the financial markets, and vice-versa. International agreements to change the supply of oil and corporate reactions to oil prices (shut-ins) are often reluctantly implemented, and the new prices must be viewed as stable at new levels for reasonably extended periods of time to justify changes in production. Moreover, both countries and corporations have complex cost structures that may keep them producing oil, even where such production has minimal economic returns in the very short-run. That applies as well to the possibility of further decreased demand, because businesses and consumers in the midst of a global economic slowdown and COVID-19 pandemic likely are not especially sensitive to price decreases such that the use of oil would increase near-term.

20 Again, we do not dispute that supply and demand fundamentals played *a role* in the overall pricing trend and declining price for oil. In fact, CME issued CME Group Advisory Notice 20-160 on April 15, 2020, explaining "testing opportunities" for "firms wishing to test . . . negative futures or strike prices in their systems" and noting that they may "utilize CME's 'New Release' testing environments, for products CL (crude oil futures) and LO (options on those futures)." This was less than a week before the April trading anomalies, and CME stated in the advisory that "[r]ecent market events have raised the possibility that certain

racing to exit the May WTI contract in order to avoid taking delivery. That is a fairly strong indication that speculative traders were at the center of the April trading anomalies, because such traders generally are unwilling and/or unable to take delivery in lieu of taking substantial losses to offset outstanding long positions. For speculative traders, that remains true even where they face negative prices and a one-month delivery period.[21]

In this regard, the following non-fundamental, financial markets influences were almost certainly contributors to irregularities in the WTI futures markets:

Poorly Executed Roll Trading by Speculators

Passive investment vehicles, like ETFs, commodity index funds and structured vehicles, may have remained in the spot month contract too long and found themselves trapped in a long squeeze (i.e., with a long futures exposure that became increasingly out of the money as the oil futures markets precipitously dropped). ETFs and similar funds replicate oil prices through paper trading, do not have the ability to accept physical delivery of oil, and must roll all of their contracts before expiration out of the front month and into future-month contracts. The best managed ETFs, similar speculative holders of futures contracts, and commodity index derivatives dealers structure rolls well before expiry and have substantial experience closing out spot month positions in an orderly manner. However, it is conceivable that a number of such traders determined to delay their rolls, in which case the downward price pressure from forced close-outs in a thinly traded market would have been exacerbated by the fact that there were few options for others to take a corresponding long exposure to stabilize the price, accept delivery, and economically store oil purchased at low, or negative, prices for resale.[22]

In fact, the market conditions near the May WTI contract's expiry provided an incentive for large futures-dependent funds to delay closing out long positions. The roll is an expensive proposition when the market is in super contango. It is conceivable that some market participant(s) determined to delay the roll as significant inflows of *speculative* institutional money to ETFs, like the massive U.S. Oil Fund ("USO"), and the production cuts agreed in mid-April by Saudi Arabia and Russia were viewed by some as a signal that the oil market was poised for a rally.[23] If spreads were expected to narrow between the spot month and

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NYMEX energy futures contracts could trade at negative or zero trade prices or be settled at negative or zero values, and that options on these futures contracts could be listed with negative or zero strike prices." CME Group Advisory Notice 20-160, Testing opportunities in CME's "New Release" environment for negative prices and strikes for certain NYMEX energy contracts (Apr. 15, 2020), available at https://www.cmegroup.com/content/dam/cmegroup/notices/clearing/2020/04/Chadv20-160.pdf.

[21] For rules governing the delivery of WTI light sweet credit oil, see NYMEX Rulebook, Chapter 200, Light Sweet Crude Oil Futures (as of May 8, 2020), available at https://www.cmegroup.com/content/dam/cmegroup/rulebook/NYMEX/2/200.pdf. One May WTI contract would require a trader to take delivery (arrange for storage) of 1,000 barrels of crude oil, which means finding a storage facility willing to accept 42,000 U.S. gallons of oil. See NYMEX, NYMEX WTI Crude Oil Futures, Contract Specifications (as of May 8, 2020), available at https://www.cmegroup.com/trading/energy/crude-oil/light-sweet-crude_contract_specifications.html.

[22] Limited storage capacity and availability may exacerbate, but not necessarily cause, the existing downward price pressure arising from poorly managed ETF rolls. Without available storage at an economic price, contract holders involved in the physical markets could not do what they normally would do to encourage such a rally: Take new long positions that they would not intend to offset, accepting delivery of the 1,000 barrels of cheap oil under each contract and putting them into storage for eventual resale. The diminishing storage in the markets probably rendered that strategy too costly, amplifying the downward inertia from speculative shorts closing out their positions to avoid delivery.

[23] USO is an ETF with a massive footprint in the WTI futures markets. In 2020 alone, USO reportedly had taken in more than $4.9 billion in new net investments, including more than $1.6 billion during the week prior to settlement. The number of USO shares reportedly ballooned from a mere 145 million shares in February to more than 1.4 billion by mid-April. See, e.g., C. Ngai, K. Greifeld, What an Oil ETF Has to Do with Plunging Oil Prices, Wash. Post, (Apr. 23, 2020), available at

the nearest contract month, those expectations may have encouraged ETFs or other structured vehicles[24] to delay the roll only to find themselves with large, leveraged positions directionally betting on oil going up, while it is precipitously going down. This kind of ill-fated trading strategy can exert too much pressure for even the most stubborn longs to remain in positions (especially with futures commission merchants ("FCMs") taking mitigating measures), all of which may have contributed to, if not caused, Monday's unprecedented free fall.[25]

Importantly for present purposes, this describes one of several well-known dangers in permitting passive ETFs and similar funds to maintain massive speculative exposures in the futures markets on physical commodities.[26] At least one structured fund, Crude Oil Treasure, sponsored by the Bank of China lost as much as $987 million over two trading days, precisely because it remained in the WTI May contract.[27] Crude Oil Treasure's role in disrupting orderly trading and the price discovery process remains under investigation. Nevertheless, while USO and similar funds reportedly executed rolls well ahead of the April events described, their continued significant market presence—multiples of Crude Oil

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https://www.washingtonpost.com/business/energy/what-an-oil-etf-has-to-do-with-plunging-oil-prices/2020/04/22/75da66d8-84f5-11ea-81a3-9690c9881111_story.html. See also S. Jakab, The Fund That Ate the Oil Market (Apr. 21, 2020), available at https://www.wsj.com/articles/the-fund-that-ate-the-oil-market-11587489608. U.S. institutional investment managers that exercise investment discretion over $100 million or more in certain securities must file a quarterly Form 13F. These filings indicate that institutional investors taking speculative views on oil prices are heavily invested in USO shares at any given point in time. March 31, 2020 filings indicate that 197 institutional owners owned approximately half of USO, and the largest shareholders included Susquehanna International Group, LLP, Susquehanna International Group, LLP, UBS Group AG, XR Securities LLC, Lodbrok Capital LLP, Goldman Sachs Group Inc., Barclays Plc, Harvest Fund Management Co., Ltd, Parallax Volatility Advisers, L.P., and Citadel Advisors LLC.

[24] It has since come to light since the April trading anomalies that an oil-linked structured product issued by the Bank of China, called "Crude Oil Treasure," relied upon a synthetic exposure to WTI crude oil futures and apparently remained in the spot month contract—with no means to accept delivery of physical crude oil—well into the last two trading days for the WTI May contract. Crude Oil Treasure may have wiped out the entirety of its investors' balances (almost a billion dollars equivalent) and has attempted to settle with its investors for 20% of their account value. See C. Koh Ping, X. Yu, Chinese Bank Tries to Calm Storm Over Investors' Oil Losses (May 6, 2020), available at https://www.wsj.com/articles/chinese-bank-tries-to-calm-storm-over-investors-oil-losses-11588764576.

[25] That is a different kind of "roll cost" than usually borne by ETFs that transact in their full investment amount as part of the roll strategy but may lose contract exposure in contango and as a result of the expected convergence with the front-month contract.

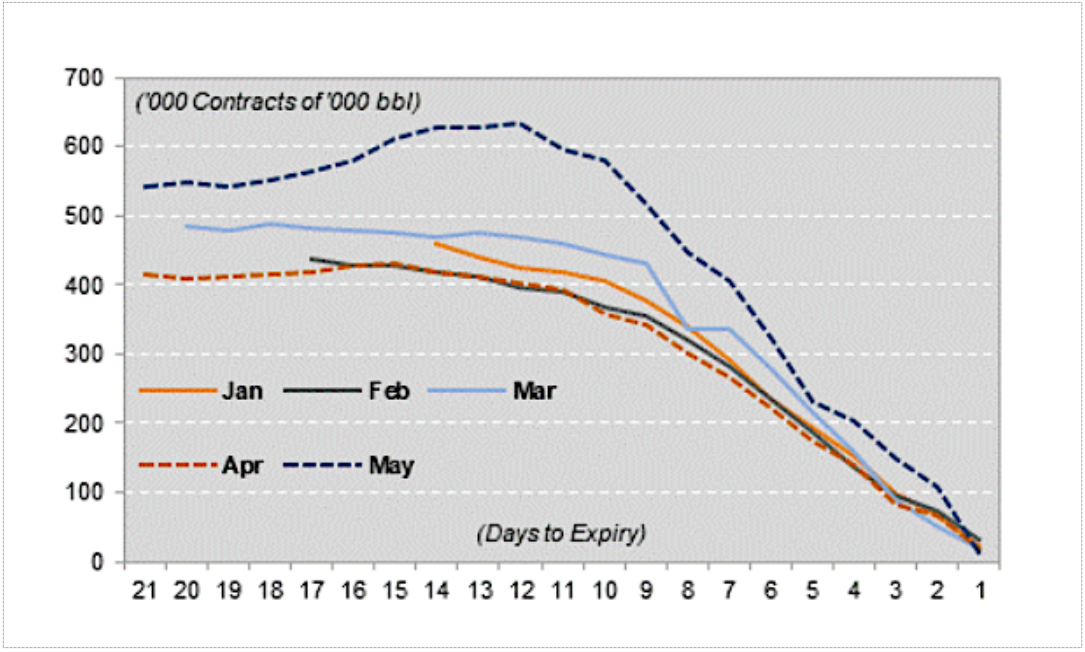
[26] Better Markets has long warned about the destabilizing presence of massive commodity index speculators in the derivatives markets and has also emphasized other concerning consequences of commodity index and ETF speculation in the derivatives markets for physical commodities. See, e.g., D. Frenk, W. Turbeville, Better Markets, Commodity Index Traders and Boom/Bust in Commodities Prices (2011), available at https://bettermarkets.com/sites/default/files/documents/Better%20Markets-%20Commodity%20Index%20Traders%20and%20Boom-Bust%20in%20Commodities%20Prices.pdf. See also M. Masters, A. White, The Accidental Hunt Brothers (July 31, 2008), available at https://www.loe.org/images/content/080919/Act1.pdf; M. Masters, A. White, The Accidental Hunt Brothers—Act 2: Special Update (Sept. 10, 2008), available at https://bettermarkets.com/sites/default/files/The%20Accidental%20Hunt%20Brothers%20-%20Part%202.pdf. See also Michael W. Masters, Testimony before the Committee on Homeland Security and Governmental Affairs, United States Senate (May 20, 2008), available at https://www.hsgac.senate.gov/imo/media/doc/052008Masters.pdf. See also I. Kaminska, Michael Masters on speculation, oil, and investment, Financial Times (Feb. 3, 2015) (noting "[y]ou need a little bit [of speculation] to grease the wheels of commerce . . . It's just that when it's all speculative flows it creates booms and busts and more volatility than is necessary for price formation to take place"), available at https://ftalphaville.ft.com/2015/02/03/2109272/a-conversation-with-michael-masters/. **Better Markets would like to incorporate these studies and comments into the administrative record for the present proposal**.

[27] See A. Cang, Z. Li, and J. Luo, Bank of China Clients Said to Lose $1 Billion on Oil Bets, Bloomberg (Apr. 26, 2020), available at https://www.bloomberg.com/news/articles/2020-04-26/bank-of-china-clients-said-to-have-1-billion-losses-on-oil-bet?sref=mQvUqJZj. See also D. Ren, Y. Liu, G. Lee, E. Ng, Bank of China oversteps regulations in passing derivatives off as wealth management. And it's not alone, South China Morning Post (May 6, 2020), available at https://www.scmp.com/business/banking-finance/article/3083191/bank-china-oversteps-regulations-passing-derivatives.

Treasure's reported position of perhaps as few as 1,400 contracts sold into the market at the worst time[28]—presents similar risks to the stability and integrity of physically settled derivatives markets and the price discovery process.

Consider the liquidation path for open interest in the May WTI spot month futures contract relative to other 2020 WTI spot month futures contracts:

Open Interest in WTI Spot Futures Contracts During the Last Month of Trading, January through May 2020



Source: NYMEX Open Interest Data, Published by Philip Verleger in Energy Intelligence[29]

Note the substantial increase in open interest that coincided with investment flows to USO, mentioned above, and differences in the liquidation pace relative to previous spot month contracts. Although a properly informed CFTC investigation is necessary to understanding the full scope of April trading activities, this presents yet another indication that trading and close-outs in the May spot month contract were anomalous.

Meaningful spot month, single month, and all-months-combined step-down position limits focused specifically on ETFs and similar speculators likely could have done much to ameliorate any sudden and unreasonable fluctuations and unwarranted price changes in the May WTI and June WTI contracts. Incidentally, meaningful position limits also would have prevented investors from making outsized investments in USO and similar ETFs and vehicles in the first place, because such limits would constrain

[28] See An analysis of the 20-minute span that changed the oil market forever, Bloomberg News (Apr. 26, 2020), available at https://www.worldoil.com/news/2020/4/24/an-analysis-of-the-20-minute-span-that-changed-the-oil-market-forever.

[29] P. Verleger, Negative Prices: Never Again, Energy Intelligence (Apr. 2020), available at http://www.energyintel.com/pages/worldopinionarticle.aspx?DocID=1070756#.

issuance of new creation units tied to the value of oil derivatives.[30] That, in turn, would beneficially diminish the imbalance of speculative interest in relation to physical hedgers and its multiple adverse effects. Note, too, that many institutional investors in commodity ETFs and similar vehicles already are substantial speculators *indirectly* and *directly* involved in the futures and options markets on physical commodities.

This should raise substantial customer protection concerns for the CFTC and other U.S. regulators. Aside from the market integrity benefits that would accrue from the limitations on speculation, ETFs and similar vehicles are too often viewed as efficient means for gaining oil and other physical commodities exposures without consideration of the risks associated with indirect participation in the derivatives markets. An intrinsic characteristic of such vehicles, however, is that they exact increasingly remarkable roll costs from investors as contango deepens (in addition to management fees). The largest such funds apparently now have been instructed to migrate their outsized presence to less liquid contract months, where their market presence is likely to be more disruptive. For example, USO alone, at different points in the April trading month, held approximately one-quarter of the open interest in certain non-spot-month WTI contracts.[31] **That means that USO and similar funds are extremely likely, in our view, to increasingly find their positions divorced from the spot price of oil in the near-term, contravening their stated speculative purpose for investors**.[32]

Furthermore, even where the roll is not involved, ETFs and similar vehicles can cause significant distortions in the derivatives markets on physical commodities. During the Tuesday trading session (the final trading day for the May WTI contract), USO reportedly held 30% of the open interest in the June WTI contract.[33] It reportedly increased that position on Tuesday, and along with one other huge ETF, traded almost 110,000 contracts or the equivalent of 19% of the previous day's open interest.[34] That kind of speculative concentration has the potential to destabilize markets, because other traders in stressed market conditions may exit their own positions at the first sign that USO and similar funds may experience

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30 In fact, USO's own prospectus acknowledges that the CFTC's proposed position limits regulations pose serious threats to its business model, given its massive speculative market presence in the futures markets. See United States Oil Fund, LP, Prospectus Filed pursuant to Rule 424(b)(3), File No. 333-237290 (March 23, 2020) ("At this time, it is unclear how the Position Limit Rules may affect USO, but the effect may be substantial and adverse. By way of example, the Position Limit Rules may negatively impact the ability of USO to meet its investment objectives through limits that may inhibit USCF's ability to sell additional Creation Baskets of USO."), available at http://www.uscfinvestments.com/documents/united-states-oil-fund-pro-20200323.pdf.

31 See, e.g., I. Bouchouev, Negative oil prices put spotlight on investors (Apr. 30, 2020), available at https://www.risk.net/investing/7536946/negative-oil-prices-put-spotlight-on-investors. See also R. Forsyth, Why Negative Oil Prices Are the Latest Financial Innovation to Cause Mischief, Barron's (Apr. 22, 2020), available at https://www.barrons.com/articles/negative-oil-prices-from-the-folks-who-brought-you-the-financial-crisis-51587549601.

32 For this reason, Better Markets is concerned about the suitability of commodity ETFs for retail investors, though that issue reaches beyond the present position limits rulemaking. See United States Oil Fund, LP, Form 8-K Current Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934, Filed with the Securities and Exchange Commission (April 21, 2020) (disclosing changes to USO's allocations across oil futures contracts and derivatives markets and emphasizing that "as a result of these changes, USO may not be able to track the Benchmark Futures Contract or meet its investment objective"), available at http://www.uscfinvestments.com/documents/united-states-oil-fund-8-k-20200421.pdf. See also United States Oil Fund, LP, Form 8-K Current Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934, Filed with the Securities and Exchange Commission (April 24, 2020) (disclosing that "in the current market and regulatory environment, significant tracking deviations can be anticipated to occur above and beyond the differences that historically occurred when the primary investment was the Benchmark Futures Contract and light, sweet crude oil futures contracts of the same month traded on ICE Futures"), available http://www.uscfinvestments.com/documents/united-states-oil-fund-8-k-20200424.pdf.

33 See J. Farchy, How ETFs, New Whales of the Oil Market, Are Roiling Prices (Apr. 22, 2020), available at https://www.bloombergquint.com/markets/how-etfs-new-whales-of-the-oil-market-are-roiling-crude-prices.

34 Id.

liquidity, redemption, and/or reallocation issues. Tellingly, a few trading days after its June roll, USO was ordered by NYMEX to close-out significant positions in WTI spot and non-spot futures positions based on "concerns about positions that USO had acquired in that [spot month] contract, as well as subsequent months."[35] That unwind coincided with a 27% drop in oil futures prices even in the most active contract, evidencing the impact that large speculative funds can have on volatility and sudden or unwarranted price fluctuations.[36]

Opportunistic Trading by Other Types of Speculators

Many speculative traders—including derivatives dealers that accommodate them through commodity swaps, structured notes, and similar offerings[37] and commercial firms ***also*** involved in the physical markets—engage in intra-day directional trading, and these speculative trading activities often are conducted in parallel with legitimate market-making and physical markets transactions. Differentiating between risk-mitigating hedging, dealing-related risk management, and purely speculative or proprietary derivatives trading activities by financial and commercial markets intermediaries can be exceedingly difficult.[38] For firms carrying substantial inventories of physical commodities, managing large commodities dealing books, or merchandizing physical commodities in significant volumes, it may be all

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[35] See United States Oil Fund, LP, Form 8-K Current Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934, Filed with the Securities and Exchange Commission (April 24, 2020), available at http://www.uscfinvestments.com/documents/united-states-oil-fund-8-k-20200424.pdf.

[36] That decline was probably more widely felt among derivatives market participants than the negative prices shortly reported in the May WTI contract, because a very significant portion of the WTI market had already shifted to the June WTI contract. See, e.g., M. DeCambre, Who may have gotten crushed—or won big—by the historic plunge below $0 a barrel for oil?, Marketwatch (Apr. 21, 2020) (quoting an industry source as stating "[w]e can't be sure how much damage the >$40 slide in WTI did to leveraged players in the spot (physical) oil markets, but we can say with confidence that today's price declines in June contracts (down 17.4%) caused more aggregate [profit-and-loss] pain than the May collapse into negative territory."), available at https://www.marketwatch.com/story/who-may-have-gotten-crushed-or-won-big-by-the-historic-plunge-below-0-a-barrel-for-oil-2020-04-20.

[37] Numerous published commodity indexes, with varying construction methodologies, are tradeable as references on derivatives. In addition, ETFs and other types of funds attempt to replicate the returns reflected in these indexes, while permitting direct investment in an exchange-traded securities instrument. For example, the S&P Goldman Sachs Commodity Index ("S&P GSCI") is a one prominent commodity index intended to approximate the performance of a broad basket of commodities weighted by global production, and it can be traded as an index futures contract on the CME. See CME Group, S&P Commodity Index Futures Contract Specs (as of May 12, 2020), available at https://www.cmegroup.com/trading/agricultural/commodity-index/gsci_contract_specifications.html. The S&P GSCI has at least tens of billions in investments tracking it through ETFs and similar trust instruments. See, e.g., iShares S&P GSCI Commodity-Indexed Trust, BlackRock (as of Mar. 31, 2020) (having net assets of approximately $501.96 million), available at https://www.blackrock.com/americas-offshore/products/239757/ishares-sp-gsci-commodityindexed-trust-fund.

[38] Furthermore, the public does not have delayed, anonymized, granular trading information that would permit it to sufficiently evaluate the nature of trading activities in the derivatives markets; that includes events on the two April trading days described. However, the CFTC's authority to conduct investigations and release information publicly is abundant and abundantly clear. CEA section 12(a) provides that the CFTC is authorized to "make such investigations as it deems necessary to ascertain the facts regarding the operations of boards of trade and other persons" subject to the CEA and "may **publish from time to time the results of any such investigation and such general statistical information gathered therefrom as it deems in the interest of the public**." 7 U.S.C. § 12(a)(1). In addition, the CFTC is authorized to "investigate the marketing conditions of commodities and commodity products and byproducts, including supply and demand for these commodities, cost to the consumer, and handing and transportation charges," and it is statutorily instructed to "**compile and furnish to producers, consumers, and distributors, by means of regular or special reports, or by such other methods as it deems most effective, information respecting the commodity markets, together with information on supply, demand, prices, and other conditions in this and other countries that affect the markets**." 7 U.S.C. § 12(d). Therefore, the CFTC is statutorily empowered and has broad latitude to publish sufficiently delayed, anonymized, granular trading information for public analysis, provided it does not "publish data and information that would **separately disclose** the business transactions or market positions of any person and trade secrets of names of customers." 7 U.S.C. § 12(a)(1). In the absence of such information for independent analysis, the public is dependent on the CFTC to thoroughly investigate April's anomalous events and release a properly informed public report.

but impossible to distinguish speculative and non-speculative trading activities, as we explain below with respect to the revised definition of "bona fide hedging transactions or positions" and enumerated hedging exemptions.

However, while derivatives dealers involved in commodity swaps and commodity futures and options markets frequently characterize themselves as "hedging" their dealing exposures in WTI and other contracts, these dealers are not hedgers at all from the perspective of their role in the derivatives markets on physical commodities. Their trading facilitates intermediation of significant exposures by financial speculators, and their hedging of that dealing in no way makes them a "hedger" in the nature of a commercial market participant. **Dealers may trade WTI futures contracts to hedge their dealing books, but *all* such activities are, in reality, an extension of speculation associated with the financialization of the commodities markets.**

These complexities are further obscured by the use of multi-legged trading strategies and certain order types. Commodity futures and physical markets intermediaries frequently trade "at settlement" to minimize basis risks between specific derivatives contracts eligible for that order type and other derivatives and physical markets positions they are meant to offset or otherwise affect. This trading-at-settlement ("TAS") order type, in theory, can be legitimately used, for example, to match derivatives pricing with physical transactions based on the derivatives settlement price (or a differential to the settlement price).[39] But some market participants have contended that TAS (1) reduces liquidity by segmenting the market, (2) impairs price competition essential to the price discovery process, (3) facilitates manipulative practices, and (4) **is used most often for large blocks executed in connection with speculative swaps dealing to commodity index investors and trades arising from the creation/redemption process of commodity ETFs.** For any speculative strategy seeking to approximate the WTI benchmark, TAS trading facilitates transactions at the settlement price for that particular trading day. But because TAS transactions are executed before they are priced, the incentives to influence the price in the meantime have been too great for some to resist.

Given the precipitous fall in price during the settlement period and the meaningful but relatively low volumes near Monday's negative close (14,913 May WTI contracts reportedly traded at negative prices,[40] not counting TAS transactions), a number of speculative traders may have engaged in opportunistic, if not manipulative, trading activities that helped to push oil prices more than $40 beyond the then-record 1986 crash.[41] One trading strategy previously employed by some traders has been to intentionally and aggressively trade the market near and during the settlement period to benefit futures or other contracts with a price fixed at the settlement price. That is why Better Markets requested that the CFTC carefully review orders and transactions in the NYMEX TAS order book,[42] which was later reported to have had unusually high volumes on the described trading days (e.g., 78,452 contracts on Monday

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[39] TAS is a capability that allows a trader to enter an order to buy or sell an eligible futures contract during the course of the trading day at a price equal to the settlement price for that contract, or at a price up to multiple ticks (minimum price fluctuations) above or below the settlement price.

[40] See L. Goodman, Inside the Biggest Oil Meltdown in History, Institutional Investor (May 6, 2020), available at https://www.institutionalinvestor.com/article/b1lhy2h328jhpt/Inside-the-Biggest-Oil-Meltdown-in-History.

[41] Id. The NYMEX WTI futures contract has been listed since March 30, 1983, so the April trading events represented one of the most extreme trading anomalies in almost 40 years.

[42] See Better Markets, With WTI Oil Futures Prices Negative, Something Is Fundamentally Wrong in The Oil Derivatives Markets--The CFTC Must Investigate Speculative Oil Trading Activities (Apr. 22, 2020), available at https://bettermarkets.com/newsroom/wti-oil-futures-prices-negative-something-fundamentally-wrong-oil-derivatives-markets-cftc.

alone).[43] The CFTC has brought numerous TAS-related enforcement actions for position limits violations, as well as "banging the close" and other disruptive/manipulative trading practices using the TAS order type, in connection with trading on oil futures.[44]

These, again, are known dangers in permitting dealers to use TAS orders in connection with their accommodation of massive speculative price exposures for commodity index investors and ETFs. Meaningful step-down position limits for dealers and commercial traders engaged in *speculative* trading in commodity futures markets could diminish the manipulative and disruptive potential of TAS trading, which may have contributed to April's unprecedented trading irregularities. Even if it did not, though, the CFTC must impose such limits as a precautionary measure. As CFTC Commissioner Dan M. Berkovitz emphasized in last week's Energy and Environmental Markets Advisory Committee, "[i]t is precisely in times of severe market stress or unusual market conditions—such as are now present in the oil market—that market participants most need the futures market to serve as an effective mechanism for price discovery and risk management."[45]

Automated Trading by Speculative Traders

Speculative traders, including those associated with proprietary trading firms and dealers' commodities trading desks, are significant participants in the futures markets, including the oil futures markets. One CFTC staff white paper on Automated Trading in Futures Markets determined, in fact, that "the level of automation has grown [for futures on all of the studied commodities], with the largest growth in the commodities starting from a lower base (e.g. crude oil)."[46] Therefore, the CFTC must consider the possibility that speculators' automated trading errors, algorithm programming flaws, or electronic momentum trading contributed to, or exacerbated, the price declines in spot month oil futures on the mentioned April trading days.

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[43] For an excellent discussion of the potential for TAS abuses, see M. Levine, It's a Good Time to Cut Dividends, Bloomberg Opinion (Apr. 29, 2020) ("The basic pattern—agree in advance to buy (sell) stuff at the official settlement price at some fixed future time, and then sell (buy) a bunch of that stuff in the minutes leading up to the official settlement time with the effect of pushing down (up) the price at which you are buying (selling)—is incredibly common, and the gradation from 'sensibly pre-hedging the exposure you will get at settlement' to 'sloppily pre-hedging the exposure you will get at settlement' to 'manipulating the market to push down the price you will get at settlement' is blurry."), available at https://www.bloomberg.com/opinion/articles/2020-04-29/it-s-a-good-time-to-cut-dividends?sref=mQvUqJZj.

[44] See CFTC, Federal Court Orders $14 Million in Fines and Disgorgement Stemming from CFTC Charges against Optiver and Others for Manipulation of NYMEX Crude Oil, Heating Oil, and Gasoline Futures Contracts and Making False Statements (Apr. 19, 2012), available at https://www.cftc.gov/PressRoom/PressReleases/pr6239-12. See also CFTC, Daniel Shak, Former Principal of SHK Management LLC, and SHK Management LLC to Jointly Pay $400,000 Penalty to Settle CFTC Charges of Attempted Manipulation of NYMEX Crude Oil Futures Contracts (Nov. 25, 2013), available at https://www.cftc.gov/PressRoom/PressReleases/pr6781-13 (consenting to position limits violations and TAS-related manipulations involving WTI crude oil futures, where the firm rapidly purchased positions to affect settlement price and benefit short TAS positions and where the firm accounted for 52.56% of the spot month open interest on one trading day and 63.55% on another). See also CFTC, CFTC Charges Optiver Holding BV, Two Subsidiaries, and High-Ranking Employees with Manipulation of NYMEX Crude Oil, Heating Oil, and Gasoline Futures Contracts (July 24, 2008), available at https://www.cftc.gov/PressRoom/PressReleases/pr5521-08. See also CFTC, Morgan Stanley Capital Group, Inc. to Pay a $14 Million Civil Penalty to Settle CFTC Charges that the Company Concealed a Large Block Crude Oil Trade (Apr. 29, 2010), available at https://www.cftc.gov/PressRoom/PressReleases/pr5816-10.

[45] CFTC Commissioner Dan M. Berkovitz, Statement on Recent Trading in the WTI Futures Contract before the Energy and Environmental Markets Advisory Committee (May 7, 2020), available at https://www.cftc.gov/PressRoom/SpeechesTestimony/berkovitzstatement050720?utm_source=govdelivery#_ftn4.

[46] See R. Haynes, J. Roberts, Automated Trading in Futures Markets—Update*, at 2 (Mar. 29, 2017), available at https://www.cftc.gov/sites/default/files/idc/groups/public/@economicanalysis/documents/file/oce_automatedtrading_update.pdf.

The WTI May contract declines were different in many respects from the trading glitches and declines experienced during the high profile 2010 Flash Crash[47] and the 2012 Knight Capital routing system meltdown.[48] Those events and automated trading concerns in other futures markets (e.g., the cattle futures markets, where traditional hedgers have derided the "meat casino" pushing away the very users the futures markets are meant to serve[49]) nevertheless demonstrate the potential for automated trading risk management and order management practices to adversely affect—as opposed to support—the integrity of the futures markets and the price discovery process. **The April oil futures events therefore should encourage the CFTC's swift adoption not only of meaningful position limits on physical commodities but also position monitoring and other risk controls contemplated by the CFTC's proposed Regulation AT**.[50]

Those market integrity measures have taken on greater urgency since Regulation AT was first proposed. The CFTC staff has observed, in fact, that crude oil futures, along with other Core Referenced Futures Contracts subject to proposed position limits, have been increasingly transacted through automated systems:[51]

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47 For a useful description of the Flash Crash, see CFTC and Securities and Exchange Commission, Findings Regarding the Market Events of May 6, 2010: Report of the Staffs of the CFTC and SEC to the Joint Advisory Committee on Emerging Regulatory Issues (Sept. 30, 2010), available at https://www.sec.gov/news/studies/2010/marketevents-report.pdf. See also A. Kirilenko et al., The Flash Crash: The Impact of High Frequency Trading on an Electronic Market (May 5, 2014), available at https://www.cftc.gov/sites/default/files/idc/groups/public/@economicanalysis/documents/file/oce_flashcrash0314.pdf. However, see also CFTC v. Nav Sarao Futures Limited plc and Navinder Singh Sarao, Case No. 15-cv-3398 (Nov. 14, 2016) (stipulating to certain facts relevant to the Flash Crash that were omitted from initial reports), available at https://www.cftc.gov/sites/default/files/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfsaraoorder111416.pdf. See also L. Vaughan, The Work-From-Home Trader Who Shook Global Markets, Bloomberg Businessweek (May 13, 2020), available at https://www.bloomberg.com/news/features/2020-05-13/new-book-shares-more-details-on-trader-blamed-for-flash-crash?sref=mQvUqJZj.

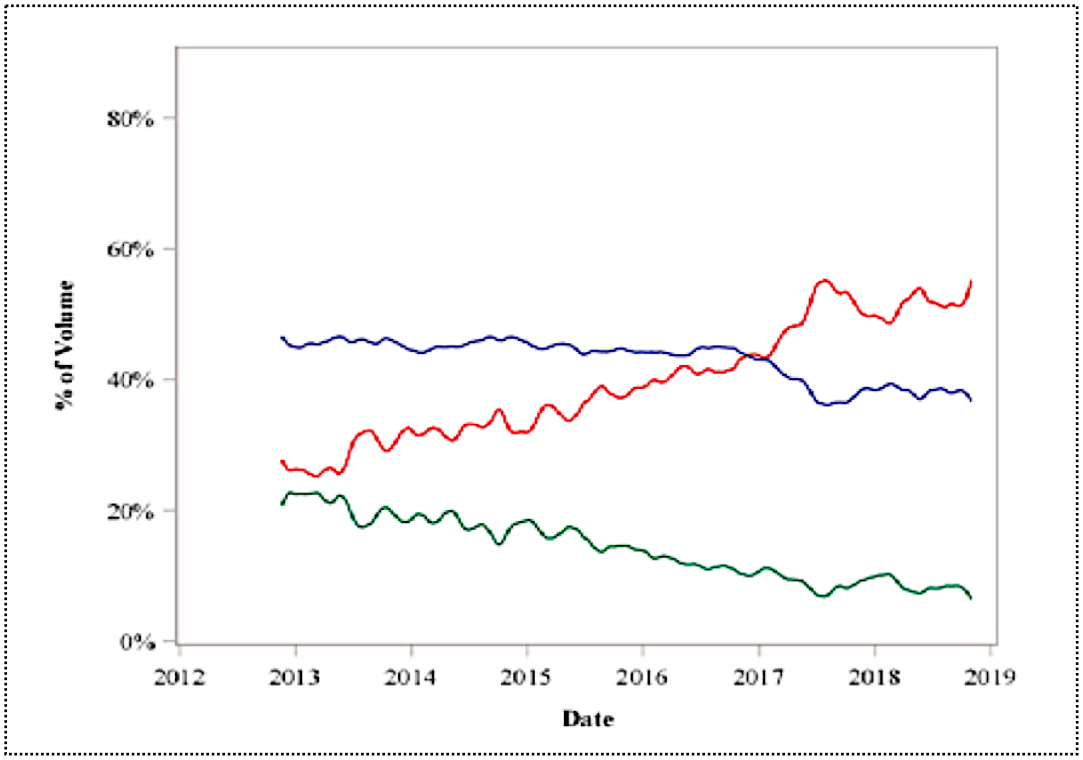
48 See Securities and Exchange Commission, In the Matter of Knight Capital Americas LLC, Release No. 70694, Administrative Proceeding File No. 3-15570 (Oct. 16, 2013)), available at https://www.sec.gov/litigation/admin/2013/34-70694.pdf.

49 See National Cattlemen's Beef Association, Letter to CME Group Executive Chairman and President, Terrence A. Duffy (Jan. 13, 2016) ("The effectiveness of cattle futures contracts as a viable risk management tool is being called into question due to the concerns over high frequency trading. In fact, we continue to hear our members question their use of the cattle contracts because the volatility has made them a tool which is more of a liability than a benefit. This is counter to the very existence of these contracts."), available at https://www.ncba.org/CMDocs/BeefUSA/Media/NCBAlettertoCMEreHFT.pdf. See also D. Murray, 'Meat Casino' pushes livestock producers, traders, away from futures market, Great Falls Tribune (Aug. 21, 2016), available at https://www.greatfallstribune.com/story/news/local/2016/08/21/meat-casino-pushes-livestock-producers-traders-away-futures-market/89085070/.

50 See CFTC, Regulation Automated Trading, 80 Fed. Reg. 78824 (Dec. 17, 2015), available at https://www.govinfo.gov/content/pkg/FR-2015-12-17/pdf/2015-30533.pdf. See also, e.g., Better Markets, Regulation Automated Trading RIN 3038-4D52 (May 1, 2017), available at https://bettermarkets.com/sites/default/files/CFTC-%20CL-%20Regulation%20Automated%20Trading-%2020170501.pdf; Better Markets, Regulation Automated Trading (CFTC RIN: 3038-AD52) (June 24, 2016), available at https://bettermarkets.com/sites/default/files/CFTC%20-%20CL%20-%20Regulation%20Automated%20Trading%20-%206-24-2016.pdf; Better Markets, Testimony on "Computerized Trading: What Should the Rules of the Road Be?," the U.S. Senate Committee on Banking, Housing, and Urban Affairs, Subcommittee on Securities, Insurance and Investment (Sept. 20, 2012), available at https://bettermarkets.com/sites/default/files/Testimony-%20Sen.%20Banking-%20Computerized%20Trading-%20%209-20-12_0.pdf. **Better Markets would like to incorporate these comment letters and this testimony into the administrative record for the present proposal**.

51 See G. Meyer, Automated trading of commodity futures accelerating (Jun. 5, 2017) (noting that "[t]he rise of trading run without human intervention has sparked controversy among the farmers, ranchers, industrial companies and hedge funds that trade futures" and that "[s]ome contend prices have become disconnected from forces of supply and demand because of algorithms"), available at https://www.ft.com/content/ae195fb6-47b0-11e7-8d27-59b4dd6296b8. See also CFTC Division of Market Oversight, Market Intelligence Branch, Impact of Automated Orders in Futures Markets (Mar. 2019) (observing that "[t]he percentage of automatically placed orders has increased for all commodity futures markets"), available at

Daily Volume Percentages for Crude Oil Futures Transactions Involving and Not Involving Automated Trading Systems
(November 1, 2012 through October 31, 2018)



Source: CFTC Staff White Paper on Automated Trading[52]

The red upward-sloping line represents transactions in crude oil derivatives in which both sides originated from an automated trading system. In addition to CFTC oversight of the most active automated trading firms and FCM and exchange trade monitoring—issues that extend beyond the current rulemaking[53]—pre-trade risk controls relating to position limits must play a role in preventing the accumulation of large positions and attendant market disruptions.

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https://www.cftc.gov/sites/default/files/2019-03/automatedordersreport032719.pdf. See also G. Meyer, Automation is the future of futures markets (Apr. 24, 2019) (quoting an industry source to support the view that "[t]he rise of automation has benefited computerised groups over investors who pore over supply-and-demand figures to take positions, at least over short periods"), available at https://www.ft.com/content/4d589796-6211-11e9-a27a-fdd51850994c.

[52] In the above chart, the CFTC staff divided total daily volume across all expirations over the past four years into (1) trades where the orders on both sides of the trade originated from an automated system (red), (2) trades where one side originated from an automated system (blue), (3) trades where neither side is an automated system (green), and (4) trades involving non-electronic execution (excluded from the graph). See R. Haynes, J. Roberts, Automated Trading in Futures Markets—Update #2, 7 (Mar. 26, 2019), available at https://www.cftc.gov/sites/default/files/2019-04/ATS_2yr_Update_Final_2018_ada.pdf. See also R. Haynes, J. Roberts, Automated Trading in Futures Markets—Update* (Mar. 29, 2017), fn. 46 supra.

[53] For a discussion of legal and other issues relating to the CFTC's oversight of automated trading systems, see G. Scopino, Do Automated Trading Systems Dream of Manipulating the Price of Futures Contracts? Policing Markets for Improper Trading Practices by Algorithmic Robots, Florida Law Review (Jan. 2016), available at https://scholarship.law.ufl.edu/cgi/viewcontent.cgi?article=1223&context=flr. See also M. Aquilina, E. Budish, and P. O'Neill, Financial Conduct Authority, Occasional Paper: Quantifying the High-Frequency Trading "Arms Race": A Simple New Methodology and Estimates (Jan. 2020), available at https://www.fca.org.uk/publication/occasional-papers/occasional-paper-50.pdf?mod=article_inline.

Federal position limits are not a panacea for all deficiencies in the derivatives markets, and they are not the sole regulatory tool that must be used to protect the integrity of the markets from speculators. Indeed, much disruptive or distortive automated trading would occur at sizes well below the CFTC's proposed position limits. Such trading activities nevertheless could have effects that undermine market integrity and the price discovery process in a manner that is similar to effects of large speculative traders. For this reason, position limits must be considered in context; that is, as a necessary element of a broader regulatory framework that emphasizes and protects the fundamental purposes of the derivatives markets to facilitate legitimate risk management and the price discovery process for physical commodities.

Lessons from the Oil Futures Irregularities in April

The key *conclusion* from this discussion is that while supply and demand fundamentals contributed to the April oil futures price declines, speculation undoubtedly also contributed, and perhaps in greater part. The key *observation* is that excess speculation does not solely affect settlement prices and impose losses on other traders; it damages the price discovery process, with real world effects on consumers and those involved in the physical commodities markets. That is why Congress has remained focused for decades not on the achievement of specific price levels but on orderly markets and the utility of position limits in addressing volatility, including the sudden or unreasonable fluctuations or unwarranted changes in the price driven by excess speculation.[54]

Furthermore, the contribution of ETFs, commodity index funds, and other speculators to these concerns cannot be seriously doubted.[55] It is apparent from numerous studies, including those conducted by CFTC economists, that the overall average daily swaps and futures (and options) open interest is skewed towards financial traders. These traders include money managers identified in the Commitment of Traders Reports (commodity trading advisors, commodity pools operators, and hedge funds) and other financial speculators, like pension funds, insurance companies, and sovereign wealth funds seeking commodities exposures to diversify investment portfolios (Note that a recent study and many before it wrongly characterize this latter category of speculative investors as "Financial *End-Users*," which, of course, is an industry encouraged misnomer because legitimate "end users" would include only firms involved in the physical commodities markets). Few dispute that speculation by these and other market participants at the levels existing in the derivatives markets on physical commodities cannot cause or at least exacerbate sudden or unreasonable fluctuations in the prices of commodities, or facilitate manipulation and other disruptions to the price discovery process.

The magnitude of the oil futures contracts traded on an average trading day is staggering by any measure. CME Group Inc. proudly advertises that the NYMEX WTI Crude Oil futures contract (CL) as a global crude oil benchmark facilitates average daily trading volume of at least 953,000 contracts.[56] Each

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54 7 U.S.C. § 6a(a)(1).

55 The historical accommodation of ETF trading in such speculative positions is not only disruptive to market integrity and distortive of the price discovery process but also a questionable accommodation to funds seeking fees from retail investors. USO, as one example with huge investment inflows and unfortunate returns in recent months, has both roll costs—which are extraordinary in super contango—and a management fee. Those costs result in a deterioration of returns over time. Unlike investments in oil producers and other types of securities involving commercial activities in the physical oil markets, including sector ETFs comprised of such securities, the passive exposures in commodity futures ETFs do not promote capital formation, innovation, or investment in productive enterprises that actually extract, refine, or beneficially merchandize oil. Such investments would be less distortive of commodities markets and a more productive social deployment of capital, and they would permit investors to maintain exposures to assets likely to be highly correlated with the commodities central to corporate revenues.

56 See CME Group Inc., Light Sweet Crude Oil (WTI) Futures and Options: Most Liquid Benchmark (accessed May 13, 2020) ("NYMEX WTI Crude Oil futures (CL) has firmly established itself as the global crude benchmark with average daily

of those futures contracts represents 1,000 barrels of crude oil, which equals 42,000 gallons oil (ignoring undoubtedly voluminous trading in spreads to WTI, other oil futures contracts, options, swaps, and inflows to ETFs and similar funds that result in subsequent activities in WTI-related derivatives markets). Thus, this one U.S. futures contract alone represented 953 million barrels of oil traded per day on average, or 40.026 billion gallons of oil.[57]

In other words, enough barrels of oil trade on average in a single trading day in the WTI contract to make approximately 19.06 billion gallons of gasoline, in addition to a significant amount of diesel.[58]

To put that figure in perspective, that means that enough oil is exchanged in a conservative 7-day trading period or so to cover all gasoline consumption in the United States. That is enough oil to fill the gas tank of every single automobile, motorcycle, light truck, light aircraft, watercraft, tool used in construction, farming, forestry, and landscaping, and electricity generator fueled by gasoline in the United States.[59]

We are unaware of any empirical basis to support the view that trading at such levels of trading and speculation are necessary to accommodate legitimate hedging transactions.[60] Much evidence, in fact, supports the view that this constitutes excess speculation and has disruptive and distortive effects on markets and commodity prices.[61] Fulsome consideration of the lengthy academic literature arriving at

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volume of 953,000 in November 2019 and open interest is up to 2.14 million contracts"), available at https://www.cmegroup.com/trading/energy/light-sweet-crude-oil.html. That average daily trading volume is more conservative than the average daily trading volume disclosed in the CME's securities filings. See fn. 78 infra.

57 The WTI crude oil contract represents 1,000 barrels of light sweet crude oil. The first figure is the product of the average daily trading in the WTI contract and the 1,000 barrels of oil represented by each contract. Each barrel is 42 gallons of oil, so the gallons of oil figure is simply the product the barrels of oil and the number of gallons per barrel.

58 See EIA, How many gallons of gasoline and diesel fuel are made from one barrel of oil?, (May 23, 2018) (noting that "[p]etroleum refineries in the United States produce about 19 to 20 gallons of motor gasoline and 11 to 12 gallons of ultra-low sulfur distillate fuel oil (most of which is sold as diesel fuel and in several states as heating oil) from one 42-gallon barrel of crude oil"), available at https://www.eia.gov/tools/faqs/faq.php?id=327&t=9. The 19.06 billion figure therefore is merely the product of the gasoline produced per barrel (approximately 20 gallons) and the number of barrels represented by trading on an average trading day (953 million).

59 U.S. Department of Transportation, Bureau of Transportation Statistics, Number of U.S. Aircraft, Vehicles, Vessels, and Other Conveyances (as of May 13, 2020), available at https://www.bts.gov/content/number-us-aircraft-vehicles-vessels-and-other-conveyances. See EIA, Gasoline explained: Use of gasoline (May 4, 2020) ("In 2019, Americans used about 142 billion gallons of motor gasoline—or about 390 million gallons per day"), available at https://www.eia.gov/energyexplained/gasoline/use-of-gasoline.php. That excludes, moreover, the number of buses, heavy trucks, and other vehicles that would be fueled by the diesel refined from the same barrels.

60 For a useful discussion of this issue and different approaches to measuring the proper balance between hedging and speculation, see, e.g., C. Gilbert, Speculative Influences on Commodity Futures Prices 2006-2008, No. 197, United Nations Conference on Trade and Development (Mar. 2010), available at https://unctad.org/en/Docs/osgdp20101_en.pdf. See also, e.g., A. Esmel, Food Speculation: Between Virtual . . . and Reality, American University International Law Review: Vol. 21: Iss. 4, Art. 1 (2016), available at https://digitalcommons.wcl.american.edu/cgi/viewcontent.cgi?referer=https://www.google.com/&httpsredir=1&article=1897&context=auilr.

61 See, e.g., M. Henn, Evidence on the Negative Impact of Commodity Speculation by Scientists, Analysts, and Public Institutions (Sept. 2011), available at https://bettermarkets.com/sites/default/files/Markus%20Henn_0.pdf. We acknowledge academic literature concluding that a number of other factors may play a significant role in the price discovery processes of commodities markets, including market fundamentals relating to globalization, trade and capital flows, the sustained low global interest rate environment, expansionary monetary policy and its potential effects on commodities priced in dollar terms, and other

conflicting conclusions in these and other commodities issues is beyond the scope of this comment letter. For present purposes, however, it is sufficient to acknowledge that the theoretical and empirical literature addressing speculation in derivatives and commodities markets contains complex studies drawing fundamentally different conclusions from fundamentally different methodologies. In addition, these studies frequently focus on the general rise of commodities prices in the lead-up to the 2008 financial crisis, which represents one particular period of time that may not be indicative of the role of speculation in driving volatility, sudden or unreasonable fluctuations in prices, or unwarranted changes in prices across markets and over time.

Fortunately, the CFTC must bring administrative expertise and experience to bear on valid statutory objectives (discussed below), and that involves far more than tallying conclusions in often incomplete and contradictory academic research. To be sure, the CFTC must have a reasoned, data-based administrative basis for its proposal and a good faith basis to believe such limits are in the public interest and serve valid statutory objectives. But it does not need evidence that meets an imaginary burden of proof placed on it by an industry commercially incentivized to sponsor studies and object to meaningful limits on speculation. The CFTC therefore must consider, but cautiously consider, any such data and studies offered in the administrative record, giving due regard to the reliability of available data, the validity of methodologies employed, the generalization of conclusions and views across markets, and the financial supporters or sponsors of such studies, among other things.[62]

In this regard, the academic literature in no way contravenes the reasoned, empirically supported view that excess speculation affects the CEA's stated statutory objectives for position limits—namely, to limit sudden or unreasonable *fluctuations* or unwarranted *changes* in commodities

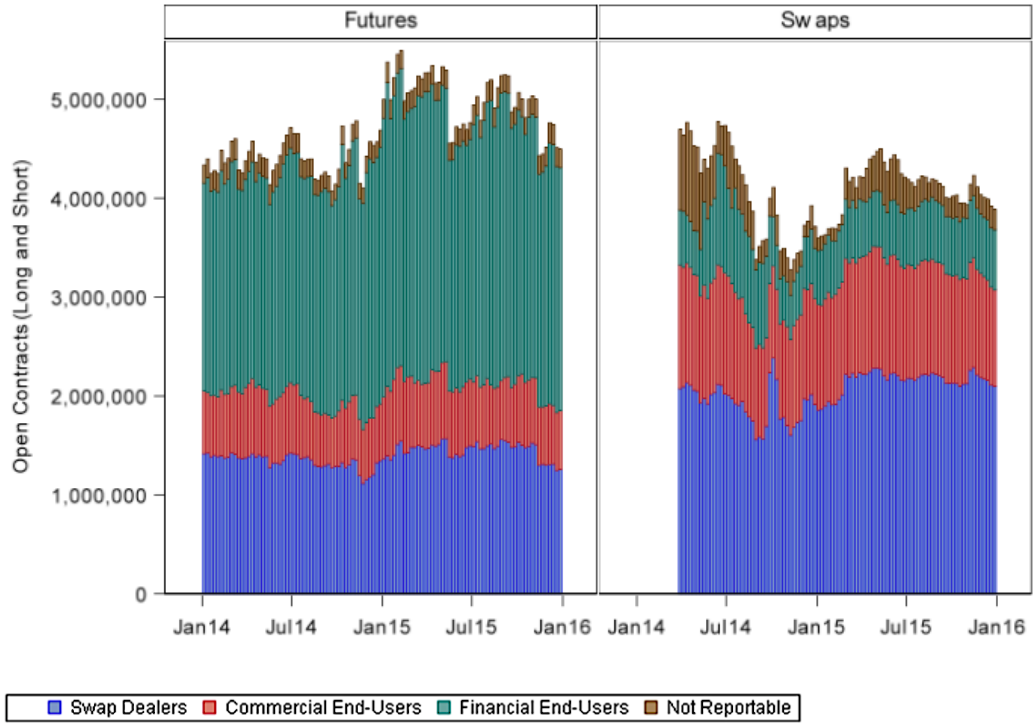
potential contributors. See, e.g., M. Haase, Y. Seiler Zimmerman, H. Zimmerman, The impact of speculation on commodity futures markets—A review of the findings of 100 empirical studies, Journal of Commodity Markets, Vol. 3(1), 1-15 (Sept. 2016) ("[T]he overall picture indicates that the number of studies which support and contradict the criticized effects of speculation is about the same"), available at https://www.sciencedirect.com/science/article/abs/pii/S2405851316300162. For another 10,000 foot view of these and other commodities issues, see, e.g., B. Fawley, L. Juvenal, Commodity Price Gains: Speculation v. Fundamentals, The Regional Economist, St. Louis Federal Reserve Bank (July 2011), available at https://www.stlouisfed.org/~/media/files/pdfs/publications/pub_assets/pdf/re/2011/c/commodities.pdf. Still numerous other studies focus on "[t]he proposed link between large flow of capital into commodity markets and increases in . . . prices" due to "speculative demand for commodity-based assets." Id at 8. See, e.g., I. Cheng, W. Xiong, The Financialization of Commodity Markets (Oct. 2013), available at https://data.nber.org/data-appendix/w19642/commodity_review6g.pdf. However, there have been a number of surveys of the academic research skeptical of that view. For example, see L. Kilian., D. Murphy, The Role of Inventories and Speculative Trading in the Global Market for Crude Oil, 29 J. Applied Econometrics 454 (2014). See also S. Irwin, D. Sanders, The Impact of Index and Swap Funds in Commodity Markets: A technical report prepared for the Organisation for Economic Co-operation and Development (June 2010), available at https://legacy.farmdoc.illinois.edu/irwin/research/Irwin_Sanders_OECD_Speculation.pdf. See also C. Knittel, R. Pindyck, The Simple Economics of Commodity Price Speculation, American Economic Journal: Macroeconomics, 85-110 (2016), available at http://web.mit.edu/rpindyck/www/Papers/CommodityPriceSpecAEJMacro2016.pdf. See also K. Miller, M. Chevalier, J. Leavens, Purvin & Gertz Inc., The Role of WTI as a Crude Oil Benchmark, Prepared for CME Group (Jan. 2010), available at https://www.bauer.uh.edu/spirrong/PurvinGertz_WTI_Benchmark_Study.pdf.

[62] The potential for mischaracterization of empirical conclusions is significant as well. Take a highly salient, often cited, non-academic opinion piece published in the New York Times by economist Paul Krugman in 2008. See P. Krugman, The Oil Nonbubble, Opinion, The New York Times (May 12, 2008), available at https://www.nytimes.com/2008/05/12/opinion/12krugman.html. That piece has been cited by those skeptical of speculation's role in causing or even exacerbating high oil prices, in part because Krugman is viewed as an unlikely critic. Krugman states that "speculators aren't the heart of the story" and raises a number of issues about market reactions to speculative bubbles and inventories that superficially could appear to cut against a version of the oil bubble narrative in 2008. Yet, in this skeptical piece, Krugman also emphasizes that "**speculators do sometimes push commodity prices far above the level justified by fundamentals**" and even explains that there would be a number of "telltale signs" when that happens. His view raises reasonable questions about whether price levels can remain "persistently" divorced from fundamentals due to speculation, not whether speculation can cause sudden or unreasonable fluctuations or unwarranted price changes (which he quite clearly acknowledges as a reality of the speculative derivatives markets).

prices and the potential for manipulation that Congress and many participants in the physical markets have observed for decades. Furthermore, it in no way contravenes the CFTC's determination to impose position limits as a precautionary measure to prevent potential harms in these areas.

In any event, the non-public market data uniquely in the CFTC's possession must be considered and prioritized. Note recently published figures on the relative participation of commercial end-users to speculative interests in the physical commodity futures and swaps markets, which we assume remains representative:

Total Open Swaps and Futures Open Interest by Market Participant Type
(January 2014 through November 2015)



Source: Scott Mixon et al Analysis of CFTC Commitment of Traders Report and Large Trader Reporting[63]

Based on data from the CFTC's Commitment of Traders ("COT") and Large Trader reports over the studied period, it is clear that the commercial end-user component continues to represent a relatively small percentage of both futures (and options) and swaps markets. One recent paper independently published by a CFTC economist, in fact, observes that **commercial end-users "appear to represent about 14% of futures open interest and 29% of open swaps**."[64] In contrast, **financial end-users (again, including**

63 See S. Mixon, E. Onur, and L. Riggs, Exploring Commodity Trading Activity: An Integrated Analysis of Swaps and Futures, Proceedings of the NCCC-134 Conference on Applied Commodity Price Analysis, Forecasting, and Market Risk Management, at 31 (April 2016), available at https://legacy.farmdoc.illinois.edu/nccc134/conf_2016/pdf/Mixon_Onur_Riggs_NCCC-134_2016.pdf.

64 Id at 12 (emphasis added).

money managers in the COT methodology and "others" generally seeking speculative exposure to commodities prices) "represent[] about 53% of futures open interest but just 16% of open swaps."[65] **These figures dramatically underestimate speculation, however, because "swap dealers" should be viewed as speculators to the extent their commodity index and other commodity swaps dealing is to such financial end-users**.

A Silver Lining, and a Cause for Alarm

There is a silver lining, however, along with further cause for concern in the particular case of the WTI futures contracts traded in mid-April. The NYMEX Market Regulation Department appears to have privately recognized the dangers of excess speculation by ETFs and similar funds during the April trading events. **USO's Form 8-K securities filings tell an alarming story, in fact, about the size of its market presence in the WTI futures markets and the market presence of speculators across the oil futures markets**. The silver lining is that NYMEX took multiple actions to mitigate the risks arising from USO and, we assume, others in the May WTI contract. USO disclosed, for example, that an April 23, 2020 letter "ordered" USO not to "assume a position in the light sweet crude oil futures contract for June 2020 in excess of 15,000 long futures contracts, for July 2020 in 78,000 long futures contracts, for August 2020 in 50,000 long futures contracts, for September 2020 in 35,000 long futures contract."[66] It explained that the NYMEX Market Regulation Department "became concerned about positions that USO had acquired in that contract and imposed limits on USO's holding of that contract, as well as subsequent months of that contract."[67]

That was NYMEX's reaction to events that had already occurred. **The greater cause for concern, however, is that this *reduced position* still would have represented a market presence of 178,000 contracts, and USO's positions in June WTI were reported to be somewhere around 150,000 contracts while the April trading events were occurring.**[68] Thus, even though USO is a speculative vehicle designed to give investors exposure to oil prices without any corresponding physical markets activities, it maintained a derivatives market position equivalent to 178,000,000 barrels of oil or almost twice total storage capacity in Cushing, Oklahoma.[69] That is also just short of the total outstanding open interest in the June WTI contract, which had 207,118 contracts in open interest as of May 8, 2020, and it

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65 Id.

66 See United States Oil Fund, LP, Form 8-K Current Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934, Filed with the Securities and Exchange Commission (April 24, 2020), available at http://www.uscfinvestments.com/documents/united-states-oil-fund-8-k-20200424.pdf. The concern with long exposure is consistent with observations made about the financial speculators throughout the derivatives markets on physical commodities. Consider S. Mixon et al., cited above, which emphasize that "[f]inancial End-Users, as a group, have net long WTI exposure in futures and in swaps, although their futures positions are larger than their swaps positions (340,000 contracts versus 190,000 contracts)." See S. Mixon, E. Onur, and L. Riggs, Exploring Commodity Trading Activity: An Integrated Analysis of Swaps and Futures, Proceedings of the NCCC-134 Conference on Applied Commodity Price Analysis, Forecasting, and Market Risk Management, at 13 (April 2016).

67 Id.

68 See, e.g., D. Kumar, T. McLaughlin, Oil price plunge below zero send 'oil tourists' on wild ride (Apr. 21, 2020), available at https://www.reuters.com/article/us-global-oil-fund/oil-price-plunge-below-zero-sends-oil-tourists-on-wild-ride-idUSKCN223186.

69 See CME Group, The Importance of Cushing, Oklahoma (as of May 8, 2020) ("This vibrant hub has 90 million barrels of storage capacity where commercial companies are active participants in the market. The storage capacity has grown dramatically over the past few years and now accounts for 13% of total U.S. oil storage."), available at https://www.cmegroup.com/education/lessons/the-importance-of-cushing-oklahoma.html. See also G. Meyer, Oil world zeroes in on Cushing, Oklahoma, Financial Times (April 24, 2020), available at https://www.ft.com/content/51d2f6a5-1a71-4c1c-b022-8768fdb72519.

would comprise 18% of the total open interest across the next four contract months combined.[70] In this regard, USO had 133,709 contracts as of May 9, 2020 (not counting pending trades) across the WTI futures curve with a total market value of $3.94 billion.[71] That is an unacceptably large footprint for a speculative vehicle competing with many other such vehicles.

There is much the public still does not know, and a fulsome policy response intended to address the trading anomalies in the May WTI contract must await the completion of a thorough investigation and public release of data-based findings. We do know, however, that excessive speculation in physical commodity markets, including oil, has the *potential* to undermine the integrity of the markets and to exacerbate sudden or unreasonable fluctuations or unwarranted changes in the price of physical commodities. We also know that these "anomalous" events, while infrequent, are highly predictable when firms actually involved in the physical markets—legitimate hedgers—comprise too small a proportion of the overall open interest.

Overreliance on Exchanges with Conflicts of Interest

The undeniable fact is that speculative trading interest has increased dramatically in recent years and has long exceeded that which is necessary to facilitate the legitimate hedging needs of those involved in the physical markets. It continues nevertheless, in part, due to the CFTC's deference to exchanges to determine for themselves the permissible level of speculation in spot months, single months, and all-months-combined. Yet, there is a very good reason not to vest that authority in exchanges alone. In the last 20 years, **these exchanges have demutualized and become for-profit enterprises that must balance the interests of their shareholders against the public interest and their commercial interests in market integrity**.[72] Unfortunately, speculation—even excess speculation—is a key revenue driver. Thus, as statutorily directed, the CFTC's must impose **federal** position limits to constrain excessive speculation that has not contributed to beneficial liquidity and yet, has contributed to instability and volatility harmful to risk management and the price discovery process.

Consider, for example, two very telling trends at NYMEX, again focused on WTI futures contracts alone, which comprise one component of one product complex for the CME exchanges:

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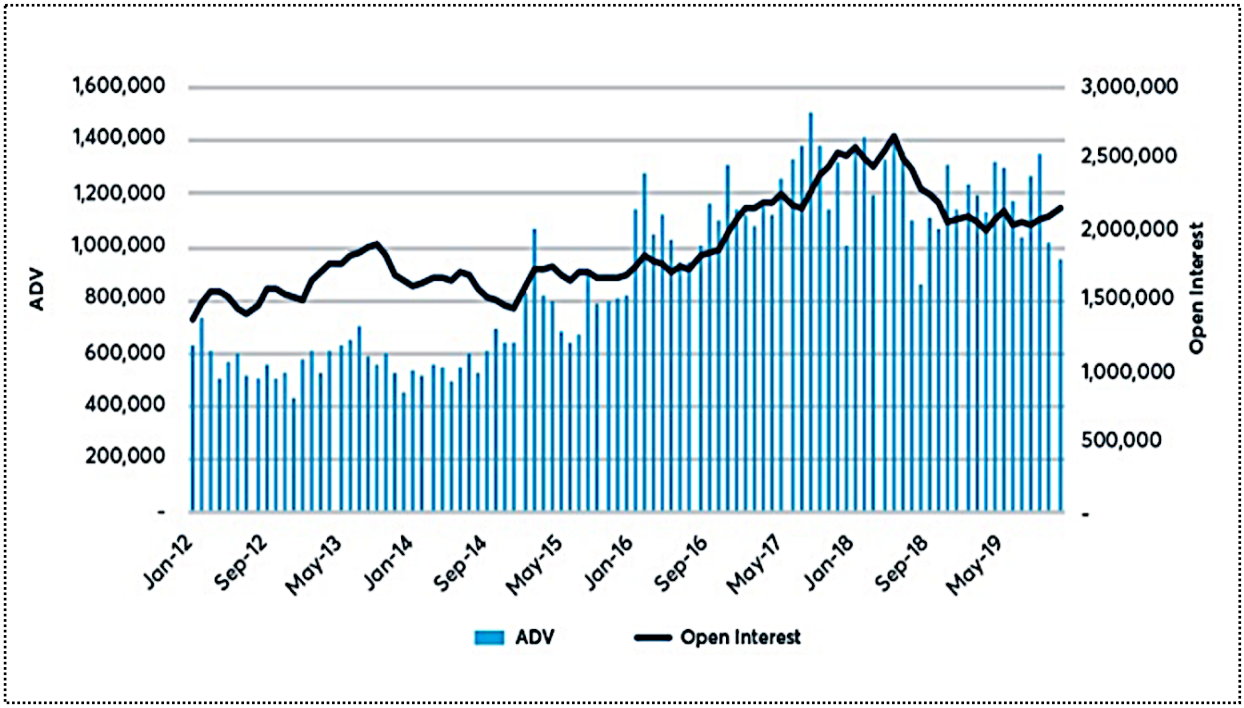
[70] This is based on the "open interest at close" statistic published by the CME as part of the Credit Oil Volume tables. See CME Group, Crude Oil Volume (as of May 8, 2020), available at https://www.cmegroup.com/trading/energy/crude-oil/light-sweet-crude_quotes_volume_voi.html?optid=425#tradeDate=20200508.

[71] See United States Oil Fund, Holdings (as of May 8, 2020), available at http://www.uscfinvestments.com/holdings/uso.

[72] The CME Group Inc. is a dominant global exchange complex that includes, among other financial markets businesses, the following designated contract markets: the Chicago Mercantile Exchange Inc. ("CME"), the Board of Trade of the City of Chicago, Inc. ("CBOT"), New York Mercantile Exchange, Inc. ("NYMEX"), Commodity Exchange, Inc. ("COMEX"), and NEX Group Limited ("NEX"). See, e.g., CME Group Inc., Form 10-Q, Filed with the Securities and Exchange Commission (For the Quarterly Period Ended Mar. 31, 2020), available at http://investor.cmegroup.com/static-files/65b13190-5a4f-416a-a9b3-642ca9af63f5. The Chicago Mercantile Exchange, Inc. demutualized on November 13, 2000, and the New York Mercantile Exchange, Inc. demutualized on November 17, 2000. In the process, "[t]he old NYMEX was converted from a not-for-profit, member-owned exchange into a Delaware for-profit stock corporation." M. Gorham, N. Singh, Electronic Exchanges: The Global Transformation from Pits to Bits, The Elsevier and IIT Stuart Center for Financial Markets Press, 118 (2009). That, of course, means CME (NYMEX) executives have a duty to their shareholders, in addition to "members" and the public, as they consider limits on speculation. That must be balanced by maintaining a threshold level of commercial activities in their markets, but CME (NYMEX) has demonstrated that these conflicting commercial considerations are unlikely to result in optimal speculation that is calibrated to public interest.

WTI Crude Oil Futures Contracts Average Daily Volume and Open Interest
2012-2020



Source: CME Group Inc.[73]

This, give or take, is representative of the increases in trading and open interest across much of the derivatives markets in the last 20 years, though a more granular analysis would reveal significant differences in these trends between different categories and markets. The key point for present purposes is that exchanges depend heavily on trading to generate networks effects in their markets and therefore stable revenues, as well as significant revenues from related offerings based on such trading (e.g., data-related offerings comprise approximately 10% of CME Group Inc.'s revenues[74]). That data is purchased by a number of different market participants on CME's exchanges, but speculators directly and indirectly serve as an important customer base and revenue source.

Meaningful position limits on derivatives on physical commodities threaten to diminish these revenues, and we are confident that the U.S. exchanges subject to the CFTC's proposal would acknowledge this fact. Consider, for example, the CME Group Inc.'s Form 10-K for the fiscal year ended December 31, 2019, which included a disclosure that "**[t]he adoption and implementation of position limits rules . . . could have a significant impact on our commodities business if federal rules for position limit**

[73] See CME Group Inc., Light Sweet Crude Oil (WTI) Futures and Options: Most Liquid Benchmark (as of May 13, 2020), available at https://www.cmegroup.com/trading/energy/light-sweet-crude-oil.html. For open interest figures in WTI derivatives over time, see EIA, What drives crude oil prices? An Analysis of 7 factors that influence oil markets, with chart data updated monthly and quarterly (May 12, 2020), available at https://www.eia.gov/finance/markets/crudeoil/reports_presentations/crude.pdf. See also CFTC Division of Market Oversight, Impact of U.S. Tight Oil on NYMEX WTI Futures, 7 (Sept. 2018), available at https://www.cftc.gov/sites/default/files/2018-09/DMO_TightOilImpactNYMEX_WTI0818.pdf.

[74] See CME Group Inc., Form 10-Q, Filed with the Securities and Exchange Commission (For the Quarterly Period Ended Mar. 31, 2020), at 20.

management differ significantly from current exchange-administered rules."[75] It further explained more broadly that "[a] reduction in overall trading volume or in certain products could render our markets less attractive to market participants as a source of liquidity, which could result in further loss of trading volume and associated transaction-based revenue" and further, that "[m]aterial decreases in trading volume would have a material adverse effect on our financial condition and operating results."[76] In addition, CME Group Inc. tellingly discloses the following as a material risk:

> **Additionally, from time to time, certain customers may represent a significant portion of the open interest in our individual product lines or contracts and a substantial decrease in their trading activity could have a negative impact on the liquidity of the particular product line or contract**.
>
> If we fail to maintain our trading volume, as a result of a loss of customers or decrease in trading activity; expand our product offerings or execution facilities; or are unable to attract new customers, our business and revenues will be adversely affected. Declines in trading volume may also negatively impact market liquidity, which could lead to further loss of trading volume.[77]

With these risks, and others, the CME and other exchanges (e.g., Intercontinental Exchange, Inc.) undoubtedly will feel compelled to dedicate significant resources to defeating meaningful position limits.

In 2019, the CME Group Inc. alone—parent of NYMEX that lists the WTI futures and options complex—had 1.454 million in average daily trading volume in agricultural commodities, 2.375 million in average trading volume in energy commodities (1.329 million in WTI crude oil[78]), and 668,000 in average daily volume across metals.[79] Those are significant commercial interests that it will be compelled to protect. Although the trading rate structure, types of members trading contracts, types of products traded, and other factors affect profitability, trading "volume has the most significant impact on [CME's] clearing and transaction fees revenue."[80] That revenue has long been substantial. **In 2019, trading in derivatives on agricultural commodities generated $452 million in revenue, trading in derivatives on energy commodities generated $683 million in revenue, and trading in derivatives on metal commodities generated $239.3 million, not counting related revenues in market data and information services (which totaled across contract lines $518.5 million).**[81] To the extent speculation exceeding reasonable federal position limits in these business lines stands to materially affect these revenues and the interests of shareholders, CME Group Inc's executives undoubtedly will balance public interest and contract integrity concerns against its commercial interests.

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75 See, e.g., CME Group Inc., Form 10-K, Filed with the Securities and Exchange Commission (For the Fiscal Year Ended Dec. 31, 2019), available at http://investor.cmegroup.com/static-files/a9ff062b-fba6-4b33-b2a8-ef1f57846d23.

76 Id at 14.

77 Id at 16-17.

78 Id at 38.

79 Id at 28, 36.

80 Id at 30.

81 Id at 62.

II. Properly calibrated position limits are necessary to protect the integrity of the commodity derivatives markets. The lack of meaningful position limits increases volatility, distorts the price discovery process, and subjects firms involved in physical commodities markets to increased hedging costs.

Speculative position limits are not a novel policy concern. The CEA has authorized federal position limits on certain agricultural futures and options contracts since its passage in 1936.[82] Before that, however, Congress recognized the dangers of speculation in the derivatives markets on physical commodities. Section 3 of the Grain Futures Act of 1922, for example, included findings that "sudden or unreasonable fluctuations" in the price of grain futures transactions "frequently occur[red] as a result of speculation, manipulation, or control" and served as "an obstruction to and a burden on interstate commerce."[83] Furthermore, by 1926, as part of its "comprehensive multi-year study of the grain markets," the Federal Trade Commission ("FTC") concluded as follows:

> The very large trader by himself may cause important fluctuations in the market. If he has the necessary resources, operations influenced by the idea that he has such power are bound to cause abnormal fluctuations in prices.
>
> Whether he is more often right than wrong and more often successful than unsuccessful, and whether influenced by a desire to manipulate or not, **if he is large enough he can cause disturbances in the market which impair its proper functioning** and are harmful to producers and consumers.[84]

That was subsequently affirmed by the Grain Futures Administration, which found in its own report in 1925 that "wide and erratic price fluctuations" in the wheat futures markets were "largely artificial and were caused primarily, either directly or indirectly, by heavy trading on the part of a limited number of professional speculators."[85]

In the aftermath of the stock market crash in 1929 and the onset of the Great Depression, that view was affirmed yet again by President Franklin Roosevelt's "formal message to the Congress recommending the regulation of securities and commodities markets to protect investors, safeguard values, and prevent 'destructive speculation'" as follows:

> It is my belief that exchanges for dealing in securities and commodities are necessary and of definite value to our commercial and agricultural life. Nevertheless, it should be our national policy to restrict, as far as possible, the use of these exchanges for purely speculative operations.
>
> I therefore recommend to the Congress the enactment of legislation providing for the regulation by the Federal Government of the operations of exchanges dealing in securities and commodities for the protection of investors, for the safeguarding of values, and so far

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82 See Dan M. Berkovitz, Testimony on "Position Limits and the Hedge Exemption, Brief Legislative History (July 28, 2009), available at https://www.cftc.gov/PressRoom/SpeechesTestimony/berkovitzstatement072809.

83 Id.

84 Id (citing the Report of the Federal Trade Commission on the Grain Trade, Vol. VII, Effects of Future Trading (1926), at pp. 293-4).

85 Id (citing Fluctuations in Wheat Futures, 69th Cong., 1st Sess., Senate Document No. 135 (June 28, 1926).

as it may be possible, for **the elimination of unnecessary, unwise, and destructive speculation**.[86]

Thus, as this much abbreviated history demonstrates, the current debate over the role of speculation in causing "sudden or unreasonable fluctuations" or "unwarranted changes" in the prices of derivatives on key commodities, and the role of U.S. regulators to contain it, has been ongoing for at least a century. Furthermore, the statutory authority for U.S. regulators to prevent excessive speculation through federal position limits has existed nearly as long, enduring dozens of amendments to the CEA over multiple decades.

With this historical perspective, the WTI irregularities discussed above must be viewed as only the most recent trading anomalies to ignite a debate on the role of speculators in the derivatives markets on physical commodities. It is noteworthy, though, that the CEA not only requires federal position limits but also imposes a requirement on DCMs to adopt speculative position limits or accountability to reduce ***the potential threat*** of market manipulation or congestion, especially during trading in the delivery month.[87] Despite a century of dramatically changing markets, Congress has repeatedly affirmed these authorities and mandates to establish position limits that protect markets from (i.e., prevent) excess speculation, including as a precautionary measure, and would have been unlikely to do so if it did not believe there was evidence of a problem.

Balancing Valid Statutory Objectives

Fortunately, Congress provided clear instruction on the valid statutory considerations that the CFTC must weigh in determining the "appropriate" level of speculation in the derivatives markets, while preventing "excess speculation." The CEA's core statutory command is that the CFTC "deter and prevent price manipulation or any other disruptions to market integrity"[88] and provide "a means for managing and assuming price risks, discovering prices, or disseminating pricing information through trading in liquid, fair, and financially secure trading facilities."[89] The protection of the price discovery process and orderly trading in derivatives markets, including through precautionary measures, is therefore statutorily paramount. In this regard, the CEA mandates a position limits framework that "diminish[es], eliminat[es], or prevent[s]" the "undue and unnecessary burden on interstate commerce" associated with "[e]xcessive speculation in any commodity under [futures] contracts . . . or swaps that perform or affect a significant price discovery function . . . causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity."[90]

Perhaps most pertinently, however, CEA section 4a(a)(3) requires the CFTC to implement federal position limits that, **to the maximum extent practicable**, achieve each of the following:

(i) Diminish, eliminate, or prevent excessive speculation;

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86 Id (citing Reprinted in Report of the House Committee on Interstate and Foreign Commerce, Securities Exchange Bill of 1934, H. Rep. No. 1383, 73d Cong., 2d Sess., at pp 1-2 (April 27, 1934)).

87 7 U.S.C. § 7(d)(5).

88 See 7 U.S.C. § 5(b) (providing that, among other things, the CEA is intended "to deter and prevent price manipulation or any other disruptions to market integrity") (emphasis added).

89 See 7 U.S.C. § 5(a) (stating that, among other things, the CEA is intended "a means for managing and assuming price risks, discovering prices, or disseminating pricing information through trading in liquid, fair, and financially secure trading facilities").

90 7 U.S.C. § 6a(a)(1).

(ii) Deter and prevent market manipulation, squeezes, and corners;

(iii) Ensure sufficient market liquidity for bona fide hedgers; and

(iv) Ensure that the price discovery function of the underlying market is not disrupted.[91]

These collective statutory objectives must guide the CFTC's proposal. However, the CEA's statutory objectives ask the CFTC to reasonably balance policy objectives by "setting limits that are low enough to prevent excessive speculation, manipulation, squeezes, and corners [and other trading practices] that could disrupt price discovery, but high enough so as not to restrict liquidity for bona fide hedgers."[92] Thus, the CFTC must interpret the word "excess" in this context to contemplate only such level of speculation as would be reasonably necessary to accommodate bona fide hedgers in the physical markets.

The CEA therefore requires line drawing that depends on the CFTC's informed administrative judgment with respect to all four specified statutory objectives. Each objective must be considered independently. Thus, for example, a speculative position that may not be of a size that it could cost effectively accommodate a manipulative scheme, like a cornering strategy, nevertheless must be limited if it would be of sufficient size to result in significant deviations from prices reflective of supply and demand. **Position limits focus on disorderly trading, disruptive trade flows, and volatilities that can arise from, or be especially damaging on account of, speculative position concentrations**. That is why Congress specifically stated that its concerns about speculation include "sudden or **unreasonable fluctuations**" in price caused by "excessive speculation" and "**unwarranted changes** in price."[93] Note the modifiers and focus on *changes in price*, not absolute price levels.

In short, Congress recognized that speculation is socially useful to the extent—and solely to the extent—that it facilitates hedging by market participants commercially involved in the physical markets. Yet, it recognized that, in *excess*, such speculation risks undermining the price discovery process and orderly trading—and perhaps facilitating manipulation. These concerns "require[] neither disapproval of purely financial instruments . . . nor a judgment about motives."[94] They merely require a realistic understanding of order books and financial markets flows.

The Fundamental Purpose of Derivatives Markets on Physical Commodities

However different views may be on the importance of the role of speculators in the derivatives markets on physical commodities, the importance of the markets for risk management and the integrity of the price discovery process can hardly be denied.

Derivatives have become inextricably tied to the non-financial economy—the productive economy—through their potential to impact the risk management and pricing of a broad range of everyday physical commodities. In the standardized derivatives markets, like the futures markets, those commodities

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91 7 U.S.C. § 6a(a)(3)(B).

92 CFTC, Position Limits for Derivatives, 39 Fed. Reg. 11596, 11625 (Feb. 27, 2020).

93 7 U.S.C. § 6a(a)(1).

94 J. Parsons, Black Gold and Fool's Gold: Speculation in the Oil Futures Market, Massachusetts Institute of Technology, Center for Energy and Environmental Research, Economia (2010), available at http://ceepr.mit.edu/files/papers/Reprint_228_WC.pdf.

range from traditional agricultural commodities, like wheat, that feeds our families,[95] to the oil that heats our homes and is required to complete deliveries and daily commutes to work,[96] to the metals used in household and industrial products.[97] In recent decades, the swaps markets have facilitated risk management in a number of physical commodities as well, directly and indirectly influencing price discovery processes in some physical commodities markets, like natural gas, and facilitating speculative investment in commodities.[98]

This nexus of the derivatives markets to the real economy contains both promise and peril. If the derivatives markets are used for risk-reducing activities and the limited market-making and speculative activities necessary to facilitate them, derivatives can serve socially useful risk management and price discovery purposes. That facilitates production, merchandizing, and consumption of commodities and products using commodities as inputs at more predictable costs and prices. But derivatives can perversely increase risks and costs they exist to reduce. In doing so, they can transfer resources to financial institutions and speculative market participants that would be better used to make investments in the real economy; in essence, siphoning resources away from more productive economic activities and diminishing the incentives to provide investments for innovations in commodities production, merchandizing, and distribution.

The externalities in such cases reach far beyond any immediate effects on traders in the financial markets. Indeed, a large proportion of the cost of living for working families in the U.S. and globally can be attributed to commodities prices and "[f]or many businesses, commodities represent the second-largest driver of variable cost, next to labor."[99] Volatility and "[s]teep, sustained increases in the cost of commodities materially affect the viability of businesses and even industries; often these price increases

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[95] The enumerated "commodities" in CEA section 1a(9) include, with certain exceptions, "wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, and all other goods and articles . . . in which contracts for future delivery are presently or in the future dealt in." 7 U.S.C. § 1a(9). There are three major U.S. wheat futures contracts traded on DCMs: (1) soft red winter wheat and hard red winter wheat contracts traded through the Chicago Board of Trade, an exchange owned by the CME Group; and (2) hard red spring wheat contracts traded through the Minneapolis Grain Exchange. See Chicago SRW Wheat Futures Contract Specifications, available at https://www.cmegroup.com/trading/agricultural/grain-and-oilseed/wheat_contract_specifications.html; see also KC HRW Wheat Futures Contract Specifications, available at https://www.cmegroup.com/trading/agricultural/grain-and-oilseed/kc-wheat_contract_specifications.html; see also Hard Red Spring Wheat Futures Contract Specifications, available at http://www.mgex.com/contract_specs.html.

[96] ICE Futures U.S. and NYMEX each facilitate trading in a broad range of energy-related futures contracts, including contracts on crude oil for various delivery points and other "exempt commodities" within the meaning of CEA section 1a(20). See 7 U.S.C. § 1a(20). See also, e.g., Crude Oil Futures Contract Specs, available at https://www.cmegroup.com/trading/energy/crude-oil/light-sweet-crude_contractSpecs_futures.html.

[97] COMEX and NYMEX each facilitate trading in a broad range of precious, base, and ferrous metals products, including gold, copper, silver, platinum, and palladium futures contracts. See, e.g., CME Group Inc., Metals Products Home (as of May 13, 2020), available at https://www.cmegroup.com/trading/metals/.

[98] For example, the CFTC's trade execution requirement currently applies to interest rate and index credit derivatives that have been "made available to trade" on SEFs and DCMs. See the CFTC's summary of swaps subject to the trade execution mandate, available at https://www.cftc.gov/sites/default/files/idc/groups/public/@otherif/documents/file/swapsmadeavailablechart.pdf.

[99] B. Fawley, L. Jubenal, Commodity Price Gains: Speculation v. Fundamentals (July 1, 2011), available at https://www.stlouisfed.org/publications/regional-economist/july-2011/commodity-price-gains-speculation-vs-fundamentals.

must be passed through to consumers."[100] The ultimate effects fall on consumers, farmers, and factory workers seeking to feed their families, operate their businesses, or heat their homes, for example, which is why position limits have been imposed on key contracts for the future delivery of agricultural commodities since 1936.[101]

III. The proposed federal position limits would apply to 25 physically settled futures contracts, linked cash-settled futures and options contracts, and economically equivalent swaps. The proposal would not apply federal position limits outside of the spot month, however, except with respect to legacy agricultural contracts.

The CFTC's proposal is a substantial and welcome expansion of the nine legacy agricultural Core Referenced Futures Contracts subject to position limits under part 150 of the CFTC's regulations, which has been 10 years in the making.[102] **Yet, the CFTC must be focused on the implementation of meaningful limits on excessive speculation, not merely the appearance of limits that may be insufficiently limiting.**

The CFTC's federal position limits historically have complemented position limits and accountability established and enforced by exchanges under the CFTC's DCM framework.[103] Under that framework, physically settled contracts in nine agricultural commodity categories have long been subject to "both federal and DCM-set limits, whereas others are subject only to DCM-set limits and/or position accountability."[104] That DCM position limits framework is "largely a historical remnant of an approach that predates cash-settled futures contracts, let alone swaps, institutional-investor interest in commodity indexes, and highly liquid energy markets."[105]

That, in part, motivated Congress' amendment of the CEA through section 737 of the Dodd-Frank Act to require the CFTC to impose federal position limits and to explicitly authorize the CFTC to apply position limits to "any group or class of traders."[106] In this regard, CEA section 4a(a)(2) instructs the CFTC, "with respect to physical commodities," to "establish" limits on the "amount of positions, as appropriate, other than bona fide hedge positions," that may be held by any person with respect to futures contracts and related options.[107] CEA section 4a(6) provides that the CFTC "shall . . . establish limits . . . on the aggregate number or amount of positions in contract based on the same underlying commodity . . . that may be held by any person . . . for each month across . . . contracts listed by [DCMs]," certain linked contracts listed on FBOTs, and "swap contracts that perform or affect a significant price discovery function with respect to

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100 Id.

101 For a concise review of the regulation of agricultural commodities since the 1930s, see Commodity Futures Trading Commission, 75 Fed. Reg. 65586 (Oct. 26, 2010), available at https://www.govinfo.gov/content/pkg/FR-2010-10-26/pdf/2010-26951.pdf (discussing implementation of Public Law 74–675, 49 Stat. 1491 (1936), which, among other things, set forth the original list of enumerated commodities and changed the name of the "Grain Futures Act" to the "Commodity Exchange Act").

102 See 17 C.F.R. part 150. Agricultural contracts include the specified commodities in the definition of "commodities" under 7 U.S.C. 1a. The term "legacy" is frequently used to describe the nine agricultural commodities subject to position limits, because 17 C.F.R. § 150.2 has applied federal position limits to these contracts, in certain iterations, for decades.

103 7 U.S.C. § 7(d)(5). See also 17 C.F.R. § 38.300.

104 CFTC, Position Limits for Derivatives, 39 Fed. Reg. 11596, 11597 (Feb. 27, 2020).

105 CFTC, Position Limits for Derivatives, 39 Fed. Reg. 11596, 11597 (Feb. 27, 2020).

106 See Section 737, Pub. L. 111–203, 124 Stat. 1376, 1722-25 (2010). 7 U.S.C. § 6a(a)(1).

107 7 U.S.C. § 6a(a)(2).

regulated entities."[108] Finally, CEA section 4a(3) instructs that the CFTC, as appropriate, "shall set limits . . . on the number of positions that may be held by any person for the spot month, each other month, and the aggregate number of positions that may be held by any person for all months."[109] The CFTC is statutorily instructed to "set limits . . . to the maximum extent practicable" to achieve the statutory purposes mentioned above.[110]

Under existing § 150.2 implemented under pre-Dodd-Frank Act legacy provisions, federal position limits apply (at all times) to futures and options contracts on nine legacy agricultural commodities, and it is a violation of the CFTC's regulations and exchange rules to exceed these federal limits without obtaining an exemption in advance. Existing § 150.2 sets forth a maximum level of speculative positions that any person may hold in a spot month, any single month, and all-months combined.[111] The CFTC requires aggregation of all controlled accounts for purposes of complying with the federal position limits framework.[112]

A. The proposal expands federal position limits to linked contracts and economically equivalent swaps. However, the proposal would exclude swaps from being economically equivalent on the basis of the settlement type.

The CFTC proposes to apply federal position limits to 25 Core Referenced Futures Contracts on metals, energy, and agricultural commodities,[113] in addition to other contracts on a futures-equivalent basis[114] that are linked or economically equivalent.[115] Linked contracts would constitute Referenced

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108 7 U.S.C. § 6a(a)(6)(A)-(C).

109 7 U.S.C. § 6a(a)(3)(A).

110 See 7 U.S.C. § 6a(a)(3)(B).

111 See 17 C.F.R. § 150.2. Aggregation of positions across commonly controlled or owned entities is a critical issue in this regard, but the CFTC continues to rely upon its final aggregation regulations adopted in 2016. See CFTC, Aggregation of Positions, 81 Fed. Reg. 91,454 (Dec. 16, 2016). See 17 C.F.R. 150.4.

112 See 127 C.F.R. § 150.4. See also CFTC, Aggregation of Positions, 81 Fed. Reg. 91454 (Dec. 16, 2016). A person's positions must be aggregated with positions for which the person controls trading or for which the person holds a 10 percent or greater ownership interest, unless an exemption applies. The CFTC's Division of Market Oversight has issued time-limited no-action relief from certain aggregation requirements. See CFTC Letter No. 19–19 (July 31, 2019), available at www.cftc.gov/csl/19-19/download.

113 CFTC, Position Limits for Derivatives, 85 Fed. Reg. 11596, 11602, fns. 27 and 28 (Feb. 27, 2020).

114 CFTC, Position Limits for Derivatives, 85 Fed. Reg. 11596, 11619 (Feb. 27, 2020) ("In order to aggregate positions in futures, options on futures, and swaps, it is necessary to adjust the position sizes, since such contracts may have varying units of trading (*e.g.,* the amount of a commodity underlying a particular swap contract could be larger than the amount of a commodity underlying a core referenced futures contract). The Commission thus proposes to adjust position sizes to an equivalent position based on the size of the unit of trading of the core referenced futures contract. The phrase ''futures- equivalent'' is used for that purpose throughout the proposed rules, including in connection with the ''referenced contract'' definition in proposed § 150.1.").

115 The definition of Referenced Contract would incorporate cash-settled futures contracts and related options that are (1) "directly or indirectly linked, including being partially or fully settled on, or priced at a fixed differential to, the price of that particular core referenced futures contract;" or (2) "directly or indirectly linked, including being partially or fully settled on, or priced at a fixed differential to, the price of the same commodity underlying that particular core referenced futures contract for delivery at the same location or locations as specified in that particular core referenced futures contract." Federal spot month limits for physically delivered and cash-settled Referenced Contracts would be subject to separate position limits, which cannot be netted against each other. The CFTC indicates that its staff will issue a workbook that would summarize the cash-settled futures contracts that would be subject to limits, and the Division of Market Oversight has stated that linked contracts may include as many as 400 contracts. The new definition for "economically equivalent swaps" includes swaps with "identical material contractual

Contracts and include any futures contracts and options on futures contracts that are "directly or indirectly linked to the price of a core referenced futures contract or to the same commodity underlying the applicable core referenced futures contract for delivery at the same location as specified in that core referenced futures contract."[116]

In addition, the proposal would apply federal position limits to swaps that are "economically equivalent" to Core Referenced Futures Contracts. It would somewhat narrowly define that term "economically equivalent" to mean having "identical material" contractual "specifications, terms, and conditions" to a Referenced Contract.[117] The CFTC emphasizes that materiality in this context would focus on provisions that "drive the economic value of the swap, including with respect to price and risk."[118] That is a reasonable starting point for the CFTC's analysis, and it rightly falls short of the narrowest possible conception of the term "economically equivalent" that would require a swap to be "identical in all respects to a referenced contract."[119] Furthermore, the CFTC prudently clarifies that most specifications, terms, and conditions in swap trading relationship documentation (e.g., day count conventions, resolution processes, choice of law, representations, etc.[120]) would not be sufficiently material to pricing and risk to be relevant for position limits purposes.[121]

Yet, the CFTC's proposal provides too much room for interpretation and avoidance. That must be remedied in the final regulations, because the CFTC's conception of economically equivalent is essentially a roadmap to structuring around federal position limits. It would undermine the purposes of regulating *economically* equivalent swaps to prevent regulatory arbitrage by elevating form over substance, even where swaps provide equivalent exposures to a particular commodity's price risks and affects a Core Referenced Futures Contract. The CFTC clarifies, in fact, and might as well advise that "[a]ny change in the material terms of such a swap . . . would render the swap no longer economically equivalent for position limits purposes," which will only encourage speculators to structure transactions in a manner that meets the letter, though not the spirit, of the CFTC's interpretation and definition. That is only further encouraged by the CFTC's definitive statement that it "would not bring an enforcement action for violating the [CFTC]'s speculative position limits against . . . market participants as long as the market participant performed the necessary due diligence and is able to provide sufficient evidence, if requested, to support its reasonable, good faith effort."[122]

Thus, despite the CFTC's efforts to retain a meaningful reach for the "economically equivalent" definition, there simply remains too much opportunity for avoidance. Economically equivalent swaps[123]

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specifications, terms, and conditions to a referenced contract." This definition is likely to be considerably narrower than the definition set forth in the CFTC's 2016 proposals.

116 CFTC, Position Limits for Derivatives, 85 Fed. Reg. 11596, 11598 (Feb. 27, 2020).

117 Id at 11598.

118 Id at 11616.

119 Id at 11616.

120 Id at 11617.

121 Id at 11618.

122 Id at 11617.

123 As mentioned above, the phrase "economically equivalent" is statutory phrase introduced in the Dodd-Frank Act. CEA section 4a(a)(2) requires the CFTC to "establish limits on the amount of positions, as appropriate, other than bona fide hedge positions, that may be held by any person with respect to [futures] contracts . . . or with respect to options on the [futures] contracts

would include those that have "identical" material contractual "specifications, terms, and conditions" to a contract subject to federal position limits (i.e., a Referenced Contract), with certain minimal deviations and a stand-alone standard for natural gas contracts.[124] That is a substantial, substantially problematic, and practically unworkable revision to the CFTC's previous conception of "economically equivalent." For example, the CFTC singles out settlement terms as examples of material contract specifications, terms, or conditions that would distinguish two contracts for position limits purposes, meaning that cash-settled swaps would not be considered "economically equivalent" to physically settled futures contracts and subject to the same federal limits. **Thus, a cash-settled swap priced by reference to a physically settled Core Referenced Futures Contract would be essentially excluded from the federal position limits on the sole basis that the swap and the Core Referenced Futures Contract have different settlement terms.**[125] That incentivizes speculative liquidity formation away from more liquid, more transparent, and more restrictive futures exchanges and to the swaps markets.[126]

In addition, the CFTC emphasizes that even exceedingly similar contracts in the same physical commodity, but with identifiable basis risks, would not necessarily be netted or aggregated. For example, a penultimate contract in the same underlying physical commodity as a spot month contract in that commodity need not be aggregated, even where the two contracts are demonstrably "significantly correlated."[127] That creates technical delineations that are largely divorced from the economic realities relating to physical commodities underlying both contracts. Furthermore, it could dramatically affect the net position subject to position limits for those firms accustomed to using economically equivalent swaps in offsetting respects. Of course, it would also substantially accommodate the commercial interests of ETFs and similar funds, including commodity index investors, that use dealer-executed commodity swaps to gain exposures, though dealers themselves potentially would be subject federal position limits in the spot month alone (as discussed with respect to proposed elimination of the risk management exemption and the revised swaps pass-through exemptions below). In short, though, that could mean dealers seek to put on dealing-related "hedging" positions in non-spot, traditionally less liquid contract months in which their speculative footprint would be most pronounced.

This is neither ambiguous nor accidental. **The CFTC proposes a deliberately "narrow definition" of "economically equivalent swaps," in particular as compared to its broad conception of**

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or commodities traded on or subject to the rules of a [DCM]." 7 U.S.C. 6a(a)(2). CEA section 4a(a)(5) requires the CFTC "establish limits on the amount of positions, including aggregate position limits, as appropriate, other than bona fide hedge positions, that may be held by any person with respect to swaps that are economically equivalent to [futures] contracts . . . or to options on . . . [such] contracts or commodities traded on or subject to the rules of a [DCM] subject to [CEA section 4a(a)(2)]."

[124] The proposal would provide a separate and much higher speculative position limit for cash-settled natural gas futures contracts for any person that holds no position in the NYMEX Henry Hub futures contract. That conditional limit would permit a speculative position of 20,000 contracts (10,000 cash-settled futures equivalent contracts per exchange, plus 10,000 economically equivalent swaps), or ten times the limit that otherwise would apply to Referenced Contracts held in conjunction with at least one Core Referenced Futures Contract. Moreover, the non-conditional limits for Henry Hub natural gas—2,000 contracts—which doubles the exchange-set spot month limit of 1,000 contracts. See CFTC, Position Limits for Derivatives, 85 Fed. Reg. 11596, 11615 (Feb. 27, 2020).

[125] See Id at 11615. To iterate, economically equivalent swaps are defined as swaps with "identical material" contractual specifications, terms and conditions to a Referenced Contract. One such material specification would include the settlement types, meaning that a physically settled swap could only be deemed economically equivalent to another physically settled Referenced Contract.

[126] Id at 11616 ("Because settlement type would be considered to be a material ''contractual specification, term, or condition,'' a cash-settled swap could only be deemed economically equivalent to a cash-settled referenced contract, and a physically-settled swap could only be deemed economically equivalent to a physically-settled referenced contract.").

[127] Id at 11617.

Referenced Contract for purposes of aggregating positions in Core Referenced Futures Contracts and linked contracts. The CFTC reasons that the narrow definition of economically equivalent is necessary as follows:

> [I]f the Commission were to adopt an alternative definition of economically equivalent swap that encompassed a broader range of swaps by including delivery dates that diverge by one or more calendar days—perhaps by several days or weeks—a speculator with a large portfolio of swaps may be more likely to be constrained by the applicable position limits and therefore may have an incentive either to minimize its swaps activity, or move its swaps activity to foreign jurisdictions. If there were many similarly situated speculators, the market for such swaps could become less liquid, which in turn could harm liquidity for bona fide hedgers.[128]

The CFTC is concerned, in other words, that a broad conception of "economically equivalent" might constrain speculative activities that are not otherwise exempted under the bona fide hedging exemptions, which is exactly what the statutory addition of "economically equivalent" swaps was intended to do.

The CFTC acknowledges as much, and there are some useful deterrent elements of the proposal. For example, the CFTC proposes prudent provisions in Proposed § 150.2(i) that would provide that a "swap contract used to ***willfully circumvent*** speculative position limits would be deemed an economically equivalent swap, and thus, a referenced contract."[129] Although the anti-evasion provision would be absolutely critical should the CFTC proceed with the proposed definition, the willful circumvention standard is difficult for the CFTC's Division of Enforcement to meet and turns, in significant part, on the CFTC's consideration of the legitimate business purpose analysis.[130] In that regard, the CFTC follows its precedent, which includes a permissive interpretation that explicitly acknowledges that "a person's specific **consideration of . . . costs or regulatory burdens, including the avoidance thereof**, is not, in and of itself, dispositive that the person is acting without a legitimate business purpose in a particular case."[131] Thus, the CFTC's iteration of the anti-evasion standards with respect to position limits cannot take the place of meaningful position limitations in the first place.

Recognizing concerns about netting positions across markets to avoid position limits, we suggest, on balance, that the CFTC' position limits framework would be best served by and would better achieve statutory objectives if the regulations used a single definitional standard for linked contracts and economically equivalent swaps. Under that recommendation, that single definitional standard would apply both to futures and options on futures for determining their status as a linked Referenced Contract and any

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128 CFTC, Position Limits for Derivatives, 85 Fed. Reg. 11596, 11616 (Feb. 27, 2020).

129 CFTC, Position Limits for Derivatives, 85 Fed. Reg. 11596, 11635 (Feb. 27, 2020) (emphasis added).

130 The "legitimate business purpose" analysis is used in other CFTC anti-evasion regulations. For example, pursuant to the CFTC's anti-evasion authority, the CFTC implemented a final "swap" definition and § 1.3(xxx)(6) that provides that any agreement, contract, or transaction that is willfully structured to evade Title VII would be deemed a "swap" for purposes the Title VII swaps framework. Noting that "the structuring of instruments, transactions, or entities to evade the requirements of the Dodd-Frank Act may be 'limited only by the ingenuity of man,'" the CFTC nevertheless emphasized that it would not "consider transactions, entities, or instruments structured in a manner solely motivated by a legitimate business purpose to constitute evasion." CFTC, Further Definition of ''Swap,'' ''Security-Based Swap,'' and ''Security-Based Swap Agreement''; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48208, 48300-48301 (Aug. 13, 2012), available at https://www.cftc.gov/sites/default/files/idc/groups/public/@lrfederalregister/documents/file/2012-18003a.pdf. The CFTC's anti-evasion provisions require complex analyses based, in part, on the approach to evasion taken in other statutory and regulatory frameworks.

131 CFTC, Position Limits for Derivatives, 85 Fed. Reg. 11596, 11635 (Feb. 27, 2020) (emphasis added).

swap (1) meeting the proposed "economically equivalent" definition; or (2) that is indirectly or directly linked to the price of a Core Referenced Futures Contract or directly or indirectly linked to the price of the same commodity underlying the Core Referenced Futures Contract. Although some contract specifications reasonably might distinguish one contract on a specific underlying physical commodity from another on that same underlier, the CFTC should treat all practically "equivalent" economic exposures to a commodity, at least regardless of settlement type, in the same set of position limits and set forth special netting rules that provide protections against avoidance.

The proposed definition already would explicitly exclude a number of types of contracts on specific commodities. The CFTC proposes to categorically exclude certain swaps based on differences in certain contract terms (e.g., delivery points for references, commodities weighted with an index) from position limits on Referenced Contracts. The CFTC apparently views such excluded contracts as sufficiently distinguishing the underlying commodities exposure from those underlying Core Referenced Futures Contracts and related Referenced Contracts. This would include location basis, commodity index, and certain trade options contracts, permitting still more speculative exposures to underlying physical commodities.

We encourage the CFTC to exercise extreme caution in categorically excluding such contracts without precise guidance on what constitutes a commodity index contract, for example, which quickly could become a means for avoid position limits. Although Proposed § 150.1 includes a provision within the definition of "economically equivalent swap" to authorize the CFTC to "make a determination that any swap or class of swaps satisfies, or does not satisfy," the proposed definition, that provision would require commission action on fairly technical and perhaps frequent determinations concerning endless permutations of terms and conditions associated with the swaps markets. Therefore, we recommend that the CFTC at least delegate authority to the director of the CFTC's Division of Market Oversight to public, from time to time as appropriate within his or her discretion, guidance with respect to specific types of terms and conditions commonly used in the industry and that might conflict with the spirit or letter of the definition.

In addition, we recommend that the CFTC clarify expectations with respect to swap dealer policies and procedures. **We recommend that the CFTC clarify and codify, in particular, that swap dealers must include an appendix in reasonably designed policies and procedures under existing § 23.601 that identifies swaps *in any manner* referencing specific physical commodities in derivatives subject to federal position limits, without regard to other terms and conditions, along with a simple notation as to whether swaps on such physical commodities have been deemed "economically equivalent" or not to Referenced Contracts.** That minimal documentation requirement would provide a fair deterrent to avoidance or evasion, because it would also require an accuracy-and-completeness certification as part of the annual swap dealer chief compliance officer report.[132] That report already must include a description of policies and procedures reasonably designed to ensure compliance with position limits and other CEA

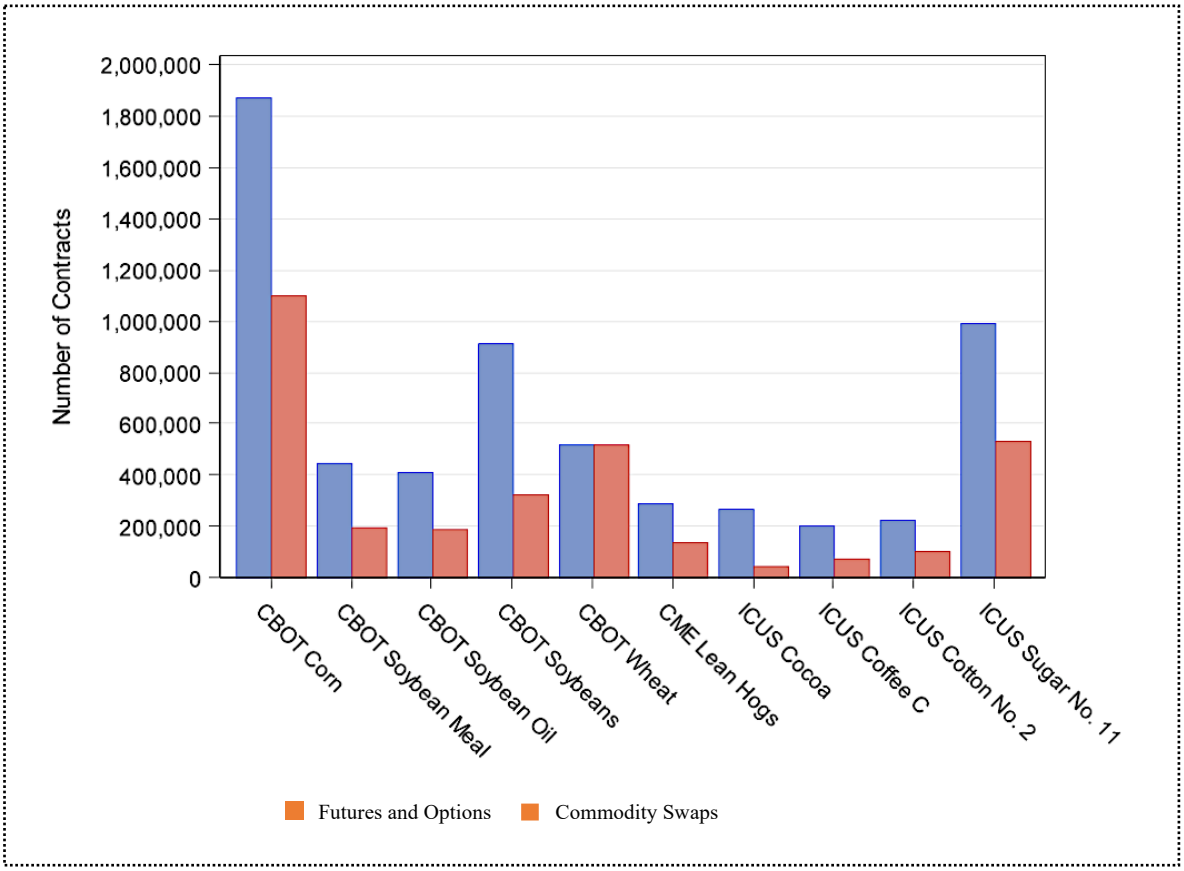
[132] 17 C.F.R. § 3.3(e) and 17 C.F.R. § 3.3(f)(3) (requiring that the swap dealer chief compliance officer report "include a certification by the chief compliance officer or chief executive officer . . . that, to the best of his or her knowledge and reasonable belief, and under penalty of law, the information contained in the annual report is accurate and complete in all material respects"). See also 17 C.F.R. § 3.3(d) (providing that the swap dealer chief compliance officer's duties "shall include . . . [a]dministering each of the [swap dealer's] policies and procedures relating to its business . . . that are required to be established pursuant to the [CEA] and Commission regulations"). See, in turn, 17 C.F.R. § 23.601 (requiring that "written policies and procedures that are reasonably designed to monitor for and prevent violations of applicable [federal] position limits . . . shall be incorporated into the risk management program").

provisions and CFTC regulations, with accompanying descriptions of effectiveness findings, testing results, and audit results.[133]

With the minimal statement of expectations that we recommend, codified as part of the final position limits regulations, such policies and procedures would provide the CFTC an adequately informed basis to consider the scope of most swaps activities on physical commodities. That can be considered alongside supervisory data and swaps data reporting.

The CFTC's conception of economic equivalence must be carefully considered, given the key complementarities and connection between the markets for swaps, futures, and options on physical commodities. In fact, even for agriculture futures and options markets, swaps comprise a material part of the markets:

Average Daily Open Swaps vs. Month-End Futures, Options Open Interest for Select Agricultural Commodities
June 2015 Reportable Positions



[133] Under § 23.601, swap dealers already must "establish and enforce written policies and procedures that are reasonably designed to monitor for and prevent violations of applicable position limits and prevent improper reliance upon any exemptions or exclusions" 17 C.F.R. § 23.601(a). In addition, swaps dealers must incorporate position limits procedures into risk management programs. See 17 C.F.R. § 23.600 and 17 C.F.R. § 23.601. See also 17 C.F.R. § 3.3(e) (requiring the swap dealer chief compliance officer report to, among other things, "contain a description of . . . the written policies and procedures" required to be established under the CEA and CFTC regulations and the swap dealer's "assessment of the effectiveness of its policies and procedures relating to its business" as a swap dealer).

Source: Scott Mixon et al., Exploring Commodity Trading Activity: An Integrated Analysis of Swaps and Futures[134]

B. The proposed spot month position limits based on a baseline measure of 25% of deliverable supply represent dramatic increases in permissible speculation and exceed the exchanges' previous recommendations.

The federal spot month speculative positions limits proposed by the CFTC for the 25 Core Referenced Futures Contracts would be set at a maximum of 25% of available deliverable supply "as estimated using recent data provided by the DCM listing the core referenced futures contract, and verified by the [CFTC]."[135] This is based, in part, on guidance in Appendix C of part 38 (applicable to DCMs) and the CFTC's recognition of its own and exchanges' historical practices.[136] However, the CFTC does not explain the means by which the DCM-provided data was collected and later "verified" in arriving at proposed spot month position limits, nor the dependencies of the DCM methodologies employed to arrive at those estimates, nor the revenue incentives for exchanges to seek to maximize speculative trading volumes, including by ETFs and similar funds, as balanced by the exchanges' need to preserve the integrity of their markets.

The ordinary and dictionary meaning of "excess" is "more than the usual, proper, or specified amount."[137] The term "excess" with respect to the phrase "excess speculation" in CEA section 4a(a)(1) therefore requires consideration of the level of speculation in a particular physical commodity derivatives contract relative to some other amount.[138] For this purpose, the CFTC's consideration of deliverable supply relative to speculative interest is rational, because it tethers speculation to in a particular physical commodities market and thereby provides a baseline measure by which the CFTC can judiciously constrain socially useless speculation. In this sense, we agree with the CFTC's rationales for the deliverable supply methodology as a starting point for constraining speculation as follows:

> By restricting positions to a proportion of the deliverable supply of the commodity, the spot month position limits require that no one speculator can hold a position larger than 25 percent of deliverable supply, reducing the possibility that a market participant can use derivatives, including referenced contracts, to affect the price of the cash commodity (and vice versa). Limiting a speculative position based on a percentage of deliverable supply also restricts a speculative trader's ability to establish a leveraged position in cash-settled derivative contracts, reducing that trader's incentive to manipulate the cash settlement price.

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134 See S. Mixon, E. Onur, and L. Riggs, Exploring Commodity Trading Activity: An Integrated Analysis of Swaps and Futures, Proceedings of the NCCC-134 Conference on Applied Commodity Price Analysis, Forecasting, and Market Risk Management, at 31 (April 2016), available at https://legacy.farmdoc.illinois.edu/nccc134/conf_2016/pdf/Mixon_Onur_Riggs_NCCC-134_2016.pdf.

135 CFTC, Position Limits for Derivatives, 85 Fed. Reg. 11596, 11599 (Feb. 27, 2020).

136 Existing § 150.5(c) provides that DCMs may adjust their speculative initial levels as follows: (i) No greater than 25 percent of deliverable supply for adjusted spot month levels in physically-delivered contracts; (ii) "no greater than necessary to minimize the potential for manipulation or distortion of the contract's or the underlying commodity's price" for adjusted spot month levels in cash-settled contracts; and (iii) for adjusted non-spot month limit levels, either no greater than 10 percent of open interest, up to 25,000 contracts, with a marginal increase of 2.5 percent thereafter, or based on position sizes customarily held by speculative traders on the DCM.

137 "Excess." Merriam-Webster Dictionary (accessed May 14, 2020), available at https://www.merriam-webster.com/dictionary/excess. Accessed 14 May. 2020.

138 7 U.S.C. § 6a(a)(1).

> Further, by proposing levels that are sufficiently low to prevent market manipulation, including corners and squeezes, the proposed levels also help ensure that the price discovery function of the underlying market is not disrupted because markets that are free from corners, squeezes, and other manipulative activity reflect fundamentals of supply and demand rather than artificial pressures.[139]

Those statements are well-reasoned and irrefutable. They do not, however, necessarily justify 25% as a threshold, nor address any ***derivatives markets*** order flows or other trading practices that have the potential to effect sudden or unreasonable fluctuations or unwarranted changes in prices of contracts on physical commodities.

Thus, while deliverable supply must be one key measure for constraining speculation, it is not sufficient to address all statutory objectives for federal position limits. The CFTC observes that multiple relevant factors were weighed in considering the levels arising from the 25% threshold calculations, including the significant changes in the derivatives markets and physical markets for key commodities since standards were adopted. The CFTC also observes changes in the markets due to the "advent of electronic trading and the implementation of extended trading hours," for example, and the fact that "open interest and trading volume have reached record levels."[140] This implicitly focuses on the effects position limits may have on current trading.

The CFTC neglects to acknowledge that the substantial increase in trading volume in Core Referenced Futures Contracts—which it observes has "reach[ed] record levels"—suggests that speculative trading has been sufficient to accommodate legitimate hedging at currently permissible levels.

Although it is possible that demand for socially useful, hedging-enabling liquidity has outpaced the dramatic increase in trading activities across derivatives on physical commodities, it is more probable that liquidity at currently permissible levels of speculation adequately accommodates hedging. Without a data-based analysis demonstrating otherwise, the CFTC must be focused on statutory objectives to curb speculation to preserve market integrity and prevent sudden, unreasonable, or unwarranted fluctuations, distortions, and volatilities arising from speculation. Instead, the CFTC appears focused on unnecessarily elevating speculation.

In recent years, liquidity across Core Referenced Futures Contracts has increased and in many cases, increased dramatically. Furthermore, the CFTC selected the 25 Core Referenced Futures Contracts subject to the most critical elements of the proposal, in part, on the basis of the substantial markets that exist relative to hundreds of other contracts referencing physical commodities. The CFTC perversely views this liquidity as granting license to permit even larger speculative positions throughout the market. Consider one passage to this effect:

> **Relative to contracts with smaller open interest, contracts with larger open interest may be better able to mitigate the disruptive impact of excessive speculation because there may be more activity to oppose, diffuse, or otherwise counter a potential pricing disruption**.[141]

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139 CFTC, Position Limits for Derivatives, 85 Fed. Reg. 11596, 11626 (Feb. 27, 2020).

140 Id at 11625.

141 Id.

In other words, the CFTC, in essence, contends that already highly liquid markets can withstand more speculation, because such speculation is more likely to be muted by other speculators and therefore less disruptive.

The view is likely simplistic. In the first instance, the nature of the speculation giving rise to open interest in non-spot contracts should be highly relevant to the appropriateness of inviting still more speculation. Broad-based, diverse, and unconcentrated speculative interest presents different considerations than a market in which a handful of traders hold almost all of the speculative trading interest near the limits. Second, the very fact that open interest has demonstrably increased, and in many cases more than doubled, in two decades suggests that bona fide hedgers are likely to find a counterparty to take their legitimate risk. Third, the CFTC has neglected to explore the issues in back-month contracts perhaps best or at least most recently demonstrated by the WTI episodes in April, where, as we have seen above, the exchange itself became substantially concerned about the sheer size of ETF exposures along the futures curve. However, again at closer read, the CFTC acknowledges the "universal observation that the size of the largest individual positions in a market do not continue to grow in proportion to increases in the overall open interest of the market."[142] That cuts against the view that the increased liquidity need be accompanied by an increase in limits, setting aside the other issues.

We draw a conclusion from that universal observation, the increased liquidity across the markets, the built-in increases in speculative interest in permissible large positions due to the relative nature of the non-spot month test, and other factors that speculative trading interest has been more than sufficient to facilitate legitimate hedging activities. Meanwhile, as WTI demonstrates, among other episodes, the potential for sudden or unreasonable fluctuations or unwarranted changes in the price of the derivatives markets on underlying commodities.

In the absence of statutorily valid liquidity concerns for bona fide hedgers, the CFTC nevertheless proposes in most cases to at least double speculative position limits. The CFTC's own conclusions could be viewed, though, as counseling a significantly lower threshold than the 25% baseline of deliverable supply, especially as that measure ignores statutorily relevant ***derivatives*** markets liquidity, trade flows, and trading practices. It would not be unreasonable for the CFTC to examine whether the observed increase in liquidity and improvement in market quality for particular Core Referenced Futures Contracts would warrant ***lower*** speculative position limits, These would likely be substantially lower as percentage of deliverable supply, depending on nature of the liquidity, the extent of the expansion of the deliverable supply in the physical markets, and the composition of trading contributing to market quality measures. **Recall that position limits apply to speculation alone.** Legitimate hedgers would remain unaffected, assuming the CFTC properly accommodates legitimate hedging tied to the physical markets and speculation continues to occur in significant enough volume to accommodate it.

However, the CFTC's observations, while mechanically valid, are statutorily invalid. The "record" open interest and trading volumes must be considered solely with respect to the liquidity needs of legitimate hedgers in the derivatives markets. That may have changed since the deliverable supply methodology was established. Nevertheless, the CFTC's own observations are highly suggestive of the fact that there is more than enough liquidity to accommodate legitimate bona fide hedgers in many, if not all, Core Referenced Futures Contracts. The CFTC notes, for example, that "the 25 core referenced futures contracts **represent some of the most liquid markets** overseen by the [CFTC],"[143] and it observes that "[w]ith the exception of CBOT Oats (O), open interest for the legacy agricultural commodities has increased dramatically over

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142 Id at 11630, fn. 216.

143 Id at 11626 (emphasis added).

the past several decades, some by a factor of four."[144] Furthermore, the CFTC concludes from internal data that "[m]arket participants have more opportunities than ever to enter, trade, or exit a position."[145] Liquidity, in other words, appears a non-issue.

The CFTC's proposed position limits framework also relies too heavily on exchange-set limits. Exchange limits that would be implemented pursuant to majestically broad standards. Like the methodology used for federal limits, "[f]or physical commodity contracts not subject to federal limits, an exchange would generally be required to set spot month limits no greater than 25 percent of [its own baseline estimates of] deliverable supply"[146] However, the CFTC explicitly "recognizes . . . that there may be circumstances where an exchange may not wish to use the 25[%] formula," in which case it would apply the existing standard for cash-settled contracts and "afford exchanges the ability to submit to the [CFTC] alternative potential methodologies for calculating spot month limit levels," provided that such limits are set at a level that is "necessary and appropriate to reduce the potential threat of market manipulation or price distortion of the contract's or the underlying commodity's price or index."[147] That deference and flexibility for exchanges insufficiently considers the conflicts of interest attendant to deference to for-profit exchanges.

Puzzling, however, is the fact that the exchanges themselves *in a very significant number of Core Referenced Futures Contracts* do not recommend limits that are anywhere near the CFTC's proposed federal position limits. In fact, the CFTC specifies in a footnote that exchange recommendations range from 7 percent of deliverable supply to 25 percent of deliverable supply, though many exchange recommendations fall well short of the 25% figure cited and proposed.[148] Consider the following comparison of exchange recommendations and federal spot month position limits proposed for the 25 commodities underlying the Core Referenced Futures Contracts:

144 Id at 11626.

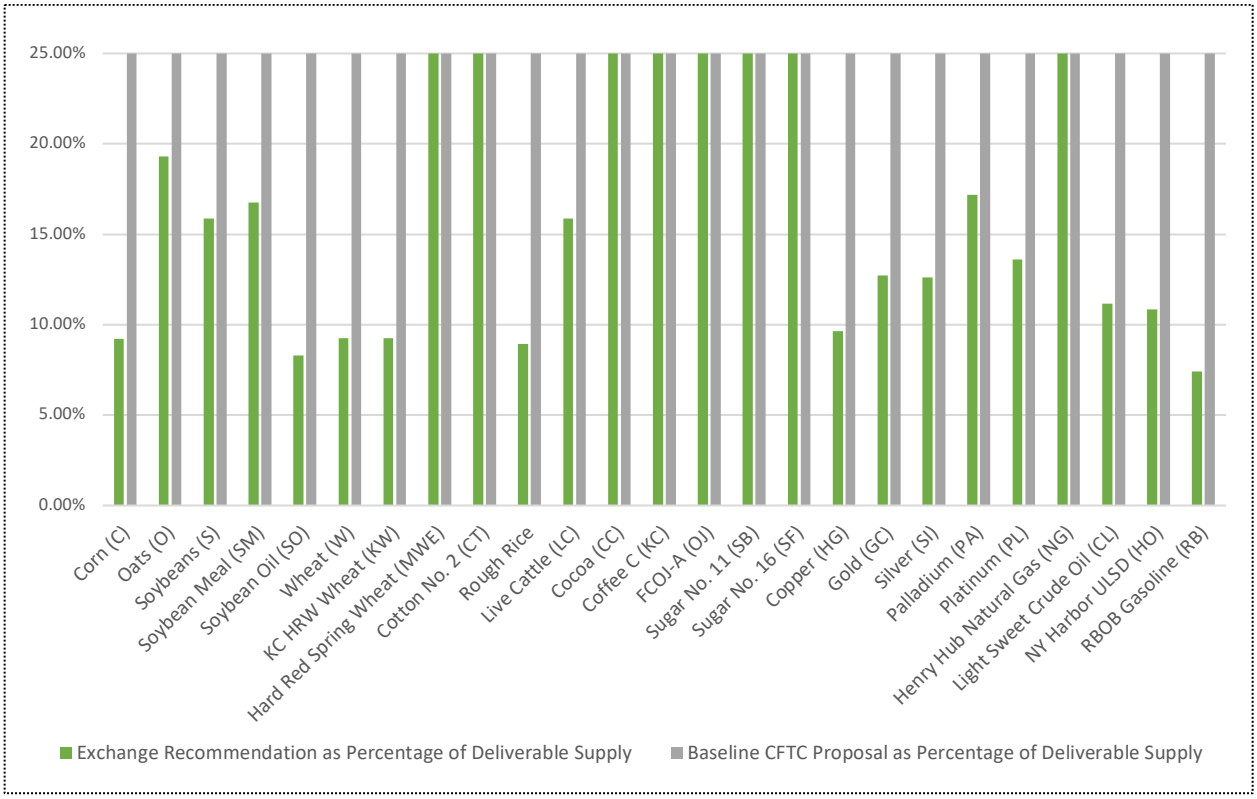
145 Id.

146 Id at 11600 (emphasis added).

147 Id at 11646.

148 Id at 11625, fn. 188.

Exchange Recommendations for Core Referenced Futures Contracts v. Proposed CFTC Federal Baseline



Source: CFTC Proposal[149]

In fact, the CFTC acknowledges that the CME exchanges indicated that their stricter percentages of deliverable supply with respect to spot month limit levels were "based on observations regarding the orderliness of liquidations and monitoring for appropriate price convergence."[150] It is very concerning that the CFTC would defer to the exchanges on a number of issues in which it believes a more "flexible" approach for position limits is warranted but would ignore the exchanges when their recommendations do not suit that agenda.

Nevertheless, the CFTC provides that such a methodology is appropriate, among other reasons,[151] to remain consistent with the thresholds "customarily used by some of the exchanges."[152] The word "some" is critical in that sentence, though, because other exchanges have taken a contract-by-contract approach to determining permissible speculation in Referenced Contracts as a percentage of deliverable supply and have arrived at widely varying recommendations that account for critical factors, like variability of estimated

149 Id at 11626, fn. 198.

150 Id at 11627.

151 The CFTC also claims that such a methodology would make it difficult for a participant to corner the market, because, in the CFTC's view, "any potential economic gains resulting from the manipulation . . . may be insufficient to justify the potential costs, including the costs of acquiring, and ultimate offloading, the positions used to effectuate the manipulation." Id at 11626. And in rather conclusory fashion, it notes that it would facilitate sufficient liquidity, or at least not diminish liquidity, for bona fide hedgers in identified markets. Id.

152 Id at 11636.

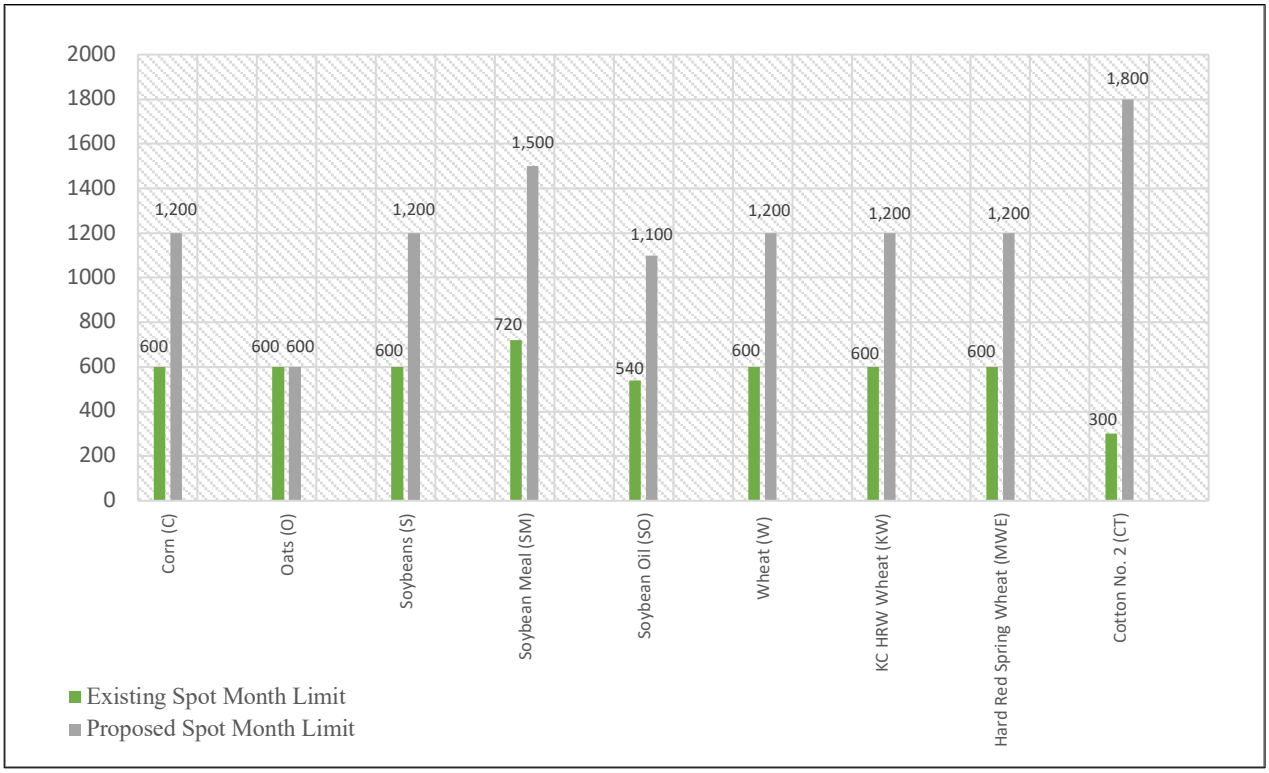
deliverable supply. Such a contract-by-contract analysis is sensible, and the exchanges have a role to play in any position limit framework, given their interests in protecting contract design, trading interest, and markets. Yet, again, the CFTC must account for the fact that the exchanges are commercial entities with profit motivations that may conflict with statutory objectives, requiring a baseline methodology that ensures speculative position limits do, in fact, limit.

For these reasons, **the CFTC must codify a rebuttable presumption that a 10%-of-deliverable-supply exchange-set spot month limit would be appropriate,[153] which is in the range of exchange-recommended outcomes for a significant number of contracts**. The CFTC should conform its federal limits to that presumption. While we are confident that a fraction of that baseline would be sufficient to provide liquidity for legitimate hedging in specific Core Referenced Futures Contracts, this initial uniform threshold would be exceedingly conservative and do much to support orderly trading and the price discovery process. It also would provide exchanges flexibility to meet a burden of proof to demonstrate that additional speculative liquidity would support, rather than harm, markets in particular contracts. Such a threshold measure could be phased-in through a multi-year compliance schedule to minimize the potential for market disruption and to facilitate changes trading practices (perhaps 25% of deliverable supply for the six months beginning after year one, to 20% for the next six months, to 15% for the subsequent six months, to 10% as a final measure).

The CFTC's proposal would, in contrast, permit increased speculation in Core Referenced Futures Contracts. Consider the thresholds proposed by the CFTC relative to the existing spot month speculative position limits for nine legacy agricultural futures contracts:

[153] Obviously, position limits under this methodology would be dependent on the exchanges' using reliance and reasonable estimates of available deliverable supply.

Federal Spot Month Position Limits for Nine Legacy Agricultural Futures Contracts
Existing v. Proposed



Source: CFTC Proposal[154]

The existing federal spot month position limits for these legacy agricultural contracts generally serve as the exchanges' spot month position limits, demonstrating the importance of the federal limitations on the exchanges' discretion.[155] One could reasonably assume that the exchange limits would increase to meet the proposed limits.

The proposed spot month position limits changes, as well as the proposed Single Month and All Months Combined position limits changes are summarized in the following chart:

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154 Id at 11599-11600.

155 The CBOT wheat contract has a series of step-down position limits that apply stricter limitations on speculation as expiry approaches (600/500/400/300/220). Id at 11599.

Summary of Changes to Federal Position Limits for Legacy Agricultural Contracts
Existing v. Proposed

Designated Contract Market	Core Referenced Futures Contract	Existing Federal Single Month and All-Months Combined Limit	Proposed Federal Single-Month and All Months Combined Limit	Existing Spot Month Limit	Proposed Spot Month Limit
Chicago Board of Trade	Corn (C)	33,000	57,800	600	1,200
Chicago Board of Trade	Oats (O)	2,000	2,000	600	600
Chicago Board of Trade	Soybeans (S)	15,000	27,300	600	1,200
Chicago Board of Trade	Soybean Meal (SM)	6,500	16,900	720	1,500
Chicago Board of Trade	Soybean Oil (SO)	8,000	17,400	540	1,100
Chicago Board of Trade	Wheat (W)	12,000	19,300	600	1,200
Chicago Board of Trade	KC HRW Wheat (KW)	12,000	12,000	600	1,200
Minneapolis Grain Exchange	Hard Red Spring Wheat (MWE)	12,000	12,000	600	1,200
ICE Futures U.S. Cotton	Cotton No. 2 (CT)	5,000	11,900	300	1,800

Source: CFTC Proposal[156]

As is clear from the above chart, the single month and all-months combined limits for the legacy agricultural commodities are generally higher, and in many cases, considerably higher, than present federal position limits. In addition, as above with respect to spot month limits, **the federal single month and all-months combined position limits serve as the existing exchange-set single month and all-months combined limits, again demonstrating that federal speculative position limits probably serve as a binding constraint**.[157]

The non-spot month limit is based on a new proposed methodology that would set federal non-spot month position limits for legacy agricultural contracts on a futures-equivalent basis at 10 percent of open interest for the first 50,000 contracts, which is a doubling of the baseline in the current methodology, which applies the 10 percent multiplier to the first 25,000 contracts.[158] In addition, the incremental increase would continue to be based on 2.5 percent of the open interest above the initial proposed threshold. The CFTC states that the new methodology is "warranted due to the significant overall increase in open interest in these markets, which has roughly doubled since federal limits were set on these markets."[159]

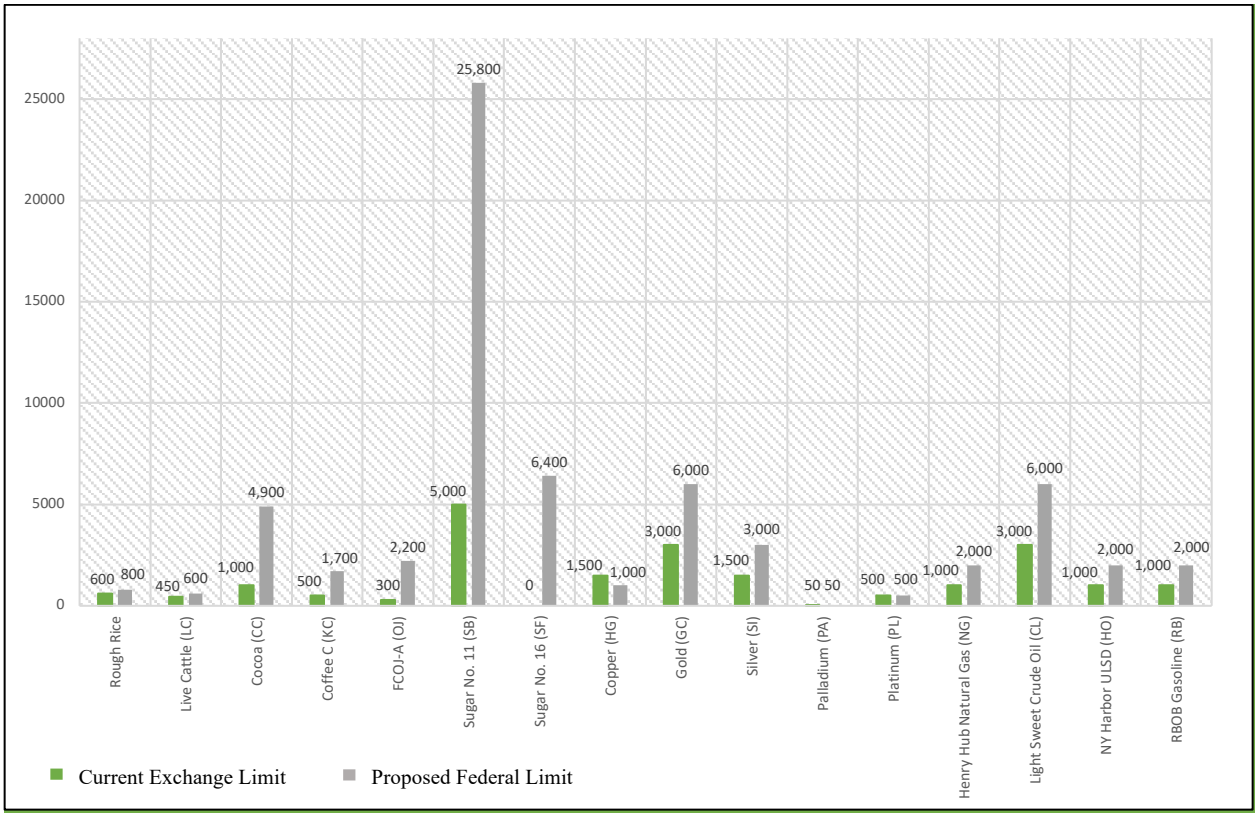
156 Id.

157 See Id at 11600.

158 Id.

159 Id at 11630.

Summary of Changes to Spot Month Position Limits for the 16 Non-Legacy Contracts
Existing Exchange v. Proposed Federal



Source: CFTC Proposal[160]

C. The proposal must establish stand-alone position limits for commodity index contracts, but the CFTC's consideration of netting and avoidance are critical and appropriate.

The proposed Referenced Contract definition would exclude commodity index contracts described in Appendix C of part 150, among other excluded types of contracts (e.g., swap guarantees, location basis contracts, and trade options meeting certain requirements[161]). As a consequence, commodity index contracts would be entirely excluded from position limits. The CFTC reasons that this exclusion is necessary as follows:

> [T]he Commission preliminarily has concluded that excluding commodity indices from the "referenced contract" definition would benefit market integrity by preventing speculators from using a commodity index contract to net down an outright position in a referenced contract that is a component of the commodity index contract, which would allow the

[160] Id at 11599, 11624-25. The existing exchange-set spot month position limits for CME Live Cattle (LC) (450/300/200) and CBOT Rough Rice (RR)(600/200/250) are step-down limits that decrease as expiry approaches. The CME Live Cattle (LC) (600/300/200) and the NYMEX Light Sweet Crude Oil (CL) (6,000/5,000/4,000) contracts are proposed to have step-down limits that would remain at or above current exchange-set limits at expiry.

[161] 17 C.F.R. § 32.3.

> speculator to take on large outright positions in the referenced contracts and therefore result in increased speculation, undermining the federal position limits framework.[162]

The CFTC's further explains the exclusion for commodity index contracts as follows:

> [T]he Commission intends that proposed § 150.2(i) **would close a potential loophole** whereby a market participant who has reached its limits could purchase a commodity index contract in a manner that allowed the participant to exceed limits when taking into account the weighting in the component commodities of the index contract. The proposed rule would close a similar potential loophole with respect to location basis contracts.[163]

Like other elements of the proposed rule, however, this reasonable concern about netting positions to avoid position limits[164] also raises concerns about ***not aggregating*** similar positions in a physical commodity and thereby permitting related positions to exist without any limits at all. Thus, balancing these two concerns, at a minimum, requires some consideration both of the avoidance concerns relating to netting and the avoidance concerns relating to aggregation. We focus our comments on the commodity index exclusion, but the principles may be equally applicable to the other exclusions (e.g., location basis contracts) that permit speculative exposures.

In the linked contract context, the CFTC takes a very different view, focusing primarily on the economic reality that "linked cash-settled contracts and physically settled contracts **form one market**, and thus should be subject to federal limits."[165] It further emphasizes that "it is common practice for the same market participant to arbitrage linked cash- and physically settled contracts, and where it has also observed instances where linked cash- and physically settled contracts have been used together as part of a manipulation."[166]

Those concerns are applicable here. For example, the CFTC also rightly acknowledges that the exclusion eliminates the most basic protection against excessive speculation:

> [T]he Commission preliminarily believes that its proposed exclusion could impose costs on market participants that trade commodity indices since, as noted, such contracts would not be subject to federal limits and thus could be more easily subject to manipulation by a market participant that obtained an excessively large position. The Commission preliminarily believes such costs would be mitigated because the commodities comprising the index would themselves be subject to limits, and because commodity index contracts generally tend to exhibit low volatility since they are diversified across many different commodities.[167]

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162 CFTC, Position Limits for Derivatives, 85 Fed. Reg. 11596, 11678 (Feb. 27, 2020).

163 Id at 11635.

164 Id at 11620 ("If the Commission did not exclude commodity index contracts, then speculators would be allowed to take on massive outright positions in referenced contracts, which could lead to excessive speculation.").

165 Id.

166 Id.

167 Id at 11679.

The CFTC focuses on the potential for improper netting to reduce commodity index positions counted towards position limits, which it worries could reduce the apparent position size without reducing negative effects.[168] The CFTC further notes that a swap, like a commodity index swap, "that is not deemed economically equivalent would not be a referenced contract, and thus could not be netted with referenced contracts **nor would be required to be aggregated with any referenced contract** for federal position limits purposes."[169]

However, the CFTC could very easily retain the anti-evasion value in limiting available netting using commodity index contracts, while applying speculative position limits tailored to those commodity index contracts. The CFTC provides no rationale for its decision to do one (limit netting), without doing the other (establishing a standalone position limit). At the very minimum, the CFTC should impose position limits on commodity index contracts for persons ***also*** involved in physically settled contracts on physical commodities serving as a constituent in the applicable index. Thus, the limits could be tailored in its application only to those involved in both Referenced Contracts and commodity index contracts relevant to those contracts.

D. Federal non-spot month position limits would apply solely to the legacy agricultural Core Referenced Futures Contracts, permitting exchanges to determine, based, in part, on commercial considerations, the appropriate amount of speculation in non-spot month contracts on remaining physical commodities.

The proposal would not apply federal position limits outside of the spot month, except as apply to these nine legacy agricultural contracts.[170] The remaining 16 Referenced Contracts would be subject to exchange-set limits and/or position accountability levels on single non-spot months and all-months-combined "consistent with [CFTC] standards,"[171] which, in theory, must be "necessary and appropriate" to reduce the "potential threat of market manipulation or price distortion of the contract's or the underlying commodity's price or index."[172] Thus, DCMs would significantly influence—indeed, control—the extent to which the proposed position limits are meaningful in practice. Furthermore, the exchanges would determine whether to apply position limits and position accountability[173] based, in part, on commercial considerations. In short, the CFTC defers far too significantly to exchange-set position limits and/or accountability levels outside of the spot month, while elevating spot month limits far above exchange recommendations.

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168 See, e.g., Id at 11615 ("[T]he [CFTC] has preliminarily determined not to propose a more inclusive 'economically equivalent swap' definition that would encompass additional swaps because such definition could make it easier for market participants to inappropriately net down against their core referenced futures contracts by allowing market participants to structure swaps that do not necessarily offer identical risk or economic exposure or sensitivity.").

169 Id.

170 The derivatives on legacy agricultural commodities have non-spot month limits set at 10 percent of open interest for the first 25,000 contracts of open interest, with a marginal increase of 2.5 percent of open interest above 20,000 contracts thereafter (which the CFTC proposes to increase to 50,000 contracts due to the substantial increase in open interest across commodities-based contracts).

171 Id at 11598.

172 Id at 11600. See also Id at 11629.

173 See Id at 11629 ("Exchange position accountability establishes a level at which an exchange will ask traders additional questions, including regarding the trader's purpose for the position, and will evaluate existing market conditions. If the position does not raise any concerns, the exchange will allow the trader to exceed the accountability level. If the position raises concerns, the exchange has the authority to instruct the trader not to increase the position further, or to reduce the position.").

This deferential framework permits exchanges choose to avoid position limits altogether, using position accountability instead.[174] Proposed Appendix F to part 150 would reflect acceptable practices in establishing position limits and position accountability levels. However, such practices merely "indicate" one means of achieving the CFTC's proposed standards.[175] Here, again, the CFTC essentially permits exchanges to codify market practices, for example specifying that exchanges would be deemed in compliance with the proposal if they set non-spot limit levels at a level no greater than "the **average historical position sizes held by speculative traders in the contract as a percentage of the contract's open interest**" or the 10/2.5 formula discussed above, among other available options. If that were not flexible enough, the CFTC iterates repeatedly that "**other parameters may be preferable and/or just as effective**" and could be implemented, provided they are certified as part 40 rule filings in compliance with proposed § 150.5(b)(2)(i).[176] Furthermore, the CFTC provides "[n]on-exclusive Acceptable Practices would provide several examples of formulas that the [CFTC] has determined would meet this standard, but an exchange would have the flexibility to develop other approaches."[177] Thus, the CFTC essentially provides that exchange can determine to apply, or not to apply, non-spot position limits as they deem commercially advisable.

Thus, the statutory and regulatory provisions applicable to discretionary exchange limits are minimal and highly deferential to the exchanges themselves. In the CFTC's own words, Proposed § 150.5 would "generally afford exchanges **the discretion to decide for themselves how best to set limit levels and grant exemptions from such limits** in a manner that best reflects their specific markets."[178] That discretion is governed primarily by minimal guidance in DCM Core Principle 5, which merely requires DCMs to adopt for each contract, as is "necessary and appropriate," position limitations or position accountability for speculators, and logically, any contract subject to a federal position limits must have a DCM limits for that contract that is no higher than the federal limit level.[179] Three CFTC divisions recently issued an advisory notice, though, on a number of complementary safeguards that market intermediaries are expected to implement, monitor, and improve.[180]

The CFTC has authority to enforce violations of both federal and exchange-set limits under CEA 4a(e).[181] However, it is doubtful that the exchanges would establish position limits at a level that would

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174 Id. Proposed § 150.5(b)(2)(i).

175 Id at 11647, fn. 320.

176 Id at 11647.

177 CFTC, Position Limits for Derivatives, 85 Fed. Reg. 11596, 11600 (Feb. 27, 2020).

178 Proposed 150.5. CFTC, Position Limits for Derivatives, 85 Fed. Reg. 11596, 11643 (Feb. 27, 2020).

179 7 U.S.C. § 7(d)(5). SEF Core Principle 6 similarly provides that SEFs that are trading facilities must adopt for each contract, as is necessary and appropriate, position limitations or position accountability for speculators, and, for any contract subject to a federal position limit, SEFs that are trading facilities must establish exchange-set limits for that contract no higher than the federal limit. 7 U.S.C. § 7b–3(f)(6). They must also monitor positions established on or through the SEF for compliance with the limit set by the Commission and the limit, if any, set by the SEF. 7 U.S.C. § 7b–3(f)(6). While SEFs are technically subject to the proposal and have position limits responsibilities under SEF Core Principles, the CFTC observes that "most economically equivalent [commodity] swaps that would be subject to federal position limits [would be] expected to be traded OTC and not executed on SEFs." CFTC, Position Limits for Derivatives, 85 Fed. Reg. 11596, 11652 (Feb. 27, 2020).

180 See CFTF Division of Clearing and Risk, CFTC Division of Market Oversight, and CFTC Swap Dealer and Intermediary Oversight, Staff Advisory on Risk Management and Market Integrity under Current Market Conditions, CFTC Letter No. 20-17 (May 13, 2020), available at https://www.cftc.gov/LawRegulation/CFTCStaffLetters/letters.htm.

181 See Id at 11633.

capture many trades that constitute violations. If the CFTC proceeds to adopt its proposed approach to non-spot month limits, we recommend at least that it amend § 150.5 as follows:

> *Exchange-set limits or accountability outside of the spot month*—(i) *Non-spot month speculative position limit or accountability levels.* For any commodity derivative contract subject to paragraph (b) of this section, a designated contract market or swap execution facility that is a trading facility shall adopt ~~either~~ speculative position limits ~~or~~ and position accountability outside of the spot month at ~~a~~ levels that ~~is necessary and appropriate to~~ reduce the potential threat of market manipulation or price distortion and the potential for sudden or unreasonable fluctuations or unwarranted changes of the contract's or the underlying commodity's price or index.[182]

The CFTC proposes to avoid the imposition of federal non-spot-month position limits, but one non-dispositive factor favoring their imposition is that existing non-spot federal and exchange limits for single month and all-months combined in the nine legacy contracts are precisely the same. This means either (1) the federal limits have served as a meaningful constraint, while maintaining sufficient liquidity; or (2) the federal limits were set so high that they have not limited single or all-months combined activities. In either case, the imposition of position limits has not hurt those critical agricultural markets, and appeared to have helped. Indeed, as mentioned above, open interest and trading in most contracts has increased substantially in recent years.

Somehow, the CFTC concludes the opposite as follows:

> Layering federal non-spot month limits for the 16 additional contracts on top of existing exchange-set limit/accountability levels may only provide minimal benefits, if any, and would forego the benefits associated with flexible accountability levels, which provide many of the same protections as hard limits **but with significantly more flexibility for market participants to exceed the accountability level** in cases where the position would not harm the market.[183]

This is incorrect in several respects. First, much is *possible*, but the CFTC does not support its assertion that federal non-spot position limits *may* provide "minimal benefits, if any." Second, imposing federal position limits on non-spot months would in no way "forgo the benefits associated with flexible accountability levels," because accountability levels would continue to be permitted within the federal non-spot month limits. The CFTC desire to permit market participants to "exceed" whatever levels established seems to be more the focus, as it describes, than the statutory objectives to limit excessive speculation that causes specific market concerns.

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182 Proposed § 150.5.

183 Id 11629 (emphasis added).

IV. The proposal would permit market participants to rely upon multiple new, self-effectuating enumerated hedging exemptions, including a proposed loophole for anticipatory merchandizing. The proposal also would permit market participants to request non-enumerated hedging exemptions from exchanges, and the new proposed application and review process would practically eliminate CFTC oversight.

The CFTC proposes a broader range of new exemptions from federal position limits for certain types of bona fide hedging transactions. There are three primary elements to the proposal. First, the CFTC proposes a new definition of "bona fide hedging transactions or positions."[184] Second, the CFTC proposes an expanded list of enumerated hedges in Appendix A to Part 150 that provides self-effectuating exemptions from federal position limits as bona fide hedges under the proposed definition. Under Proposed § 150.3(a)(1)(i), bona fide hedge recognitions for positions in Referenced Contracts that meet any of the enumerated hedges that would be listed in Appendix A would meet the bona fide hedging definition set forth in CEA section 4a(c)(2)(A).[185] Third, the CFTC provides a new process for requesting non-enumerated hedges (i.e., those that do not fall within Appendix A). Market participants may request approval for an exemption for bona fide hedges that are not listed in proposed Appendix A by demonstrating to an exchange or the CFTC that they meet the definition of a bona fide hedge, and such requests would be governed by a new process.[186]

A. The proposed "bona fide hedging transactions or positions" definition opens too many avenues to avoiding, if not evading, position limits.

CEA section 4a(c)(1) provides that position limits shall not apply to transactions or positions "which are shown to be bona fide hedging transactions or positions as such terms shall be defined by the [CFTC]."[187] That provision also provides that bona fide hedging transactions or positions "may" be defined to "permit producers, purchasers, sellers, middlemen, and users of a commodity or a product derived therefrom to hedge their **legitimate** anticipated business needs for that period of time into the future for which an appropriate futures contract is open and available on an exchange."[188] The CFTC is statutorily directed to define a "bona fide hedging transaction or position" as a transaction or position that meets the following:

- Represents a substitute for transactions made or to be made, or positions taken or to be taken, at a later time in a physical marketing channel ("Temporary Substitute Test");[189]

- Is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise ("Economically Appropriate Test");[190] and

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184 Proposed § 150.1. See Proposed § 150.3.

185 7 U.S.C. § 6a(c)(1). Market participants would remain responsible for complying with exchange position limits, unless they apply for and receive exemptions from the applicable exchange's limits.

186 17 C.F.R. § 150.3(a)(1)(ii) and (b).

187 7 U.S.C. § 6a(c)(1).

188 Id (emphasis added).

189 CFTC, Position Limits for Derivatives, 85 Fed. Reg. 11596, 11600 (Feb. 27, 2020). 7 U.S.C. § 6a(c)(2)(A)(i) and 17 C.F.R. § 1.3.

190 Id.

- Arises from the potential change in value of actual or anticipated assets, liabilities, or services ("Change-In-Value Requirement").[191]

The CFTC proposes substantially revised regulatory text and interpretations implementing the first two prongs of the statutory definition.

The CFTC's position limits have multiple statutory purposes, but the first among equals, so-to-speak, is simply preventing "excessive speculation." To prevent excessive speculation, however, the CFTC must provide a framework that reasonably distinguishing speculative positions from other types of positions, like hedging positions, which rightly should be excluded from speculative position limits if properly defined and confined. The proposed new definition of "bona fide hedging transactions or positions"[192] in Proposed § 150.1, along with important interpretations, would permit market participants to exceed federal position limits if Referenced Contracts positions satisfy three elements of the "bona fide hedging transactions or positions" definition.[193] The first subsection (i.e., not hedging subsections relating to pass-through swaps and spread exemptions) would adhere closely to CEA section 4a(c)(2)'s bona fide hedging definition.[194]

Although the CFTC proposes sensible modifications and interpretations of elements of the "bona fide hedging transaction or positions" definition, **the CFTC is too often concerned about accommodating industry "hedging" practices (or *supposed* hedging practices) in a manner that insufficiently balances such concerns with statutory concerns unrelated, and even in conflict with, current industry practices characterized as hedging**. In this regard, present practices and unsupported assertions by market participants seeking minimal oversight of their trading activities cannot be the sole focus of the CFTC with respect to bona fide hedging recognitions. Yet, the CFTC nearly obsessively concerns itself throughout the release with "tak[ing] into account future changes in industry practices and other developments"[195] and "accomodat[ing] changing hedging practices over time."[196] The preamble repeatedly clarifies that "proposed modifications would provide a significant degree of flexibility to market participants in terms of how they hedge."[197] **These repeated statements reveal almost a singular focus on accommodating industry practices on the apparent assumption that such practices per se balance statutory concerns about minimizing the disruptions, distortions, and unwarranted market fluctuations or changes in prices associated with excessive speculation**.

In other words, the "bona fide hedging transaction or positions" definition and related descriptions appear to reflect a "market-knows-best" philosophy that is untethered to Congress' statutory objectives and instructions. The prudent anti-evasion provisions in Proposed 150.2(i) notwithstanding,[198] this deference

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191 Id.

192 17 C.F.R. § 150.3(a)(1).

193 Proposed § 150.1 (defining "bona fide hedging transactions or positions"). CFTC, Position Limits for Derivatives, 85 Fed. Reg. 11596, 11600 (Feb. 27, 2020).

194 Id.

195 CFTC, Position Limits for Derivatives, 85 Fed. Reg. 11596, 11605 (Feb. 27, 2020).

196 Id.

197 Id at 11605.

198 Proposed § 150.2(i) would provide that a bona fide hedge recognition or spread exemption would no longer apply if used to willfully circumvent or evade speculative position limits. CFTC, Position Limits for Derivatives, 85 Fed. Reg. 11596, 11635

to industry practices remains an avenue to avoidance, if not evasion, of the federal position limits framework, with minimal practical oversight.

Elimination of the Risk Management Exemption

The CFTC must retain critically important changes to its 1987 interpretation of the Temporary Substitute Test based on statutory changes instituted by the Dodd-Frank Act. Specifically, it revises the Temporary Substitute Test to require that a bona fide hedging transaction or position in a physical commodity "must *always*, and not just *normally*, be connected to the production, sale, or use of a physical cash-market commodity."[199] This proper acknowledgement of Congress' intent in amending the Temporary Substitute Test's statutory text has critically policy implications; namely, closing the risk management exemption loophole relied upon by swap dealers.

In this regard, the CFTC's statutory interpretation adheres to CEA section 4a(c)(2)(A)(i)'s Temporary Substitute Test, which provides that bona fide hedging transactions or positions must "represent a substitute for transactions made or to be made or positions taken or to be taken at a later time in a physical marketing channel."[200] That language is a result of the Dodd-Frank Act's amendment of that provision to delete the word "normally" that has formed the basis for the permissive bona fide hedging definition, which continues to provide merely that a bona fide position must "normally" represent a substitute for transactions in a physical marketing channel.[201]

Modifying the CFTC's definition to reflect corresponding changes in the statutory enabling language is common sense statutory interpretation and good public policy. **Most importantly, as a consequence of the proposed change to the Temporary Substitute Test, the CFTC *rightly* interprets CEA amendments effected by the Dodd-Frank Act as statutorily eliminating its authority to grant so-called "risk management" exemptions relied upon by swap dealers to facilitate dealing and speculative activities**. The proposal therefore would not permit so-called "risk management" positions to be treated as "bona fide hedging transactions or positions" by swap dealers. The CFTC that it views that interpretation as following "Congressional direction that a bona fide hedging position in physical commodities must *always* (and not just 'normally') be in connection with the production, sale, or use of a physical cash-market commodity."[202]

The nullification of the CFTC's recognition of the risk management exemption is long overdue and evident from the CFTC's description of the exemption:

> In connection with physical commodities, the phrase "risk management exemption" has historically been used by [CFTC] staff to refer to non-enumerated bona fide hedge recognitions granted under § 1.47 to allow swap dealers and others to hold agricultural futures positions outside of the spot month in excess of federal limits in order **to offset**

(Feb. 27, 2020) ("This provision is intended to help ensure that bona fide hedge recognitions and spread exemptions are granted and utilized in a manner that comports with the CEA and Commission regulations, and that the ability to obtain a bona fide hedge recognition or spread exemption does not become an avenue for market participants to inappropriately exceed speculative position limits.").

199 Id at 11601.

200 7 U.S.C. § 6a(c)(2)(A)(i).

201 See, e.g., 17 C.F.R. § 1.3.

202 CFTC, Position Limits for Derivatives, 85 Fed. Reg. 11596, 11605 (Feb. 27, 2020).

commodity index swap or related exposure, typically opposite an institutional investor for which the swap was not a bona fide hedge.[203]

In other words, in such a dealing exemption, the purpose of the supposed "risk management" derivatives transaction is to "offset" speculative risk exposures, not to "substitute" or stand in for a current or near-future transaction in physical commodities. The dictionary and ordinary meaning of the word, "substitute," used by Congress is instructive: "to take the place of" or "to put or use in the place of another."[204] Thus, the statutory requirement is that the bona fide hedging transaction or position must take the place of a transaction "in a physical marketing channel," meaning the derivatives position excluded from position limits must be tied to transactions in physical commodities, which intermediation for institutional investors in this context (i.e., swap dealing) simply is not.

The CFTC must finalize the elimination of the risk management exemption in light of the Dodd-Frank Act's amendments to the Temporary Substitute Test. We agree with the CFTC's conclusion that "given the statutory change[s] [in the Dodd-Frank Act], positions that reduce the risk of such swaps and financial instruments would no longer meet the requirements of CEA section 4a(c)(2)," as reflected in Proposed § 150.1.[205] In doing so, the CFTC must reject inevitable requests that it re-recognize, or even expand, the 1987 interpretation "that a futures position could still qualify as a bona fide hedging position even if it was not in connection with the production, sale, or use of a physical commodity,"[206] which amounts to an unlawful and now statutorily prohibited loophole.

Swap dealers, their proxies and allies, and other speculative traders are almost certain to contend that the elimination of the risk management exemption would impact "liquidity" by curbing legitimate market-making activities. Some of that concern will relate to dealing involving commodity index swaps and similar types of financial instruments excluded elsewhere in the CFTC's proposal, like commodity index contracts that should be given their own stand-alone position limits. This means, in essence, that the full directional positions in related futures and options products that are hedged with or hedge commodity index swaps and similar would be subject to the proposed position limits, without regard for whether those positions offset others in the swaps markets and similar.

For this reason, we agree with the CFTC's determination to indirectly limit dealing to customers in commodity index swaps by limiting directional exposure in the most natural hedging market for those activities, while also limiting the distortive effect associated with hedging in markets intended to support legitimate hedgers involved in the physical markets.

Legitimate hedging relating to physical commodities through derivatives markets must not be jeopardized by those seeking exposures for investment, speculative, or dealing reasons.

Economically Appropriate Test

The CFTC proposes an amendment of the Economically Appropriate Test that would make explicit that the word "risks" for purposes of CEA section 4a(c)(2)'s bona fide hedging transactions or positions

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203 Id at 11605, fn. 57 (emphasis added). See also CFTC, Position Limits for Derivatives, 85 Fed. Reg. 11596, 11601 (Feb. 27, 2020).

204 See, e.g., "Substitute," Merriam-Webster.com Dictionary, Merriam-Webster (accessed May 15, 2020), available at https://www.merriam-webster.com/dictionary/substitute.

205 CFTC, Position Limits for Derivatives, 85 Fed. Reg. 11596, 11606 (Feb. 27, 2020).

206 Id at 11605, fn. 56 (emphasis added).

definition is limited to "price risk," the proper historical focus of the CFTC in this context. We agree with the CFTC's proposed reasoning for this amendment as follows, which is worth citing at length:

> [R]e-interpreting "risk" to mean something other than "price risk" would make determining whether a particular position is economically appropriate to the reduction of risk too subjective to effectively evaluate. **While the Commission or an exchange's staff can objectively evaluate whether a particular derivatives position is an economically appropriate hedge of a price risk arising from an underlying cash-market transaction, including by assessing the correlations between the risk and the derivatives position, it would be more difficult, if not impossible, to objectively determine whether an offset of non-price risk is economically appropriate for the underlying risk.**
>
> For example, for any given non-price risk, such as political risk, there could be multiple commodities, directions, and contract months which a particular market participant may view as an economically appropriate offset for that risk, and multiple market participants might take different views on which offset is the most effective. **Re-interpreting "risk" to mean something other than "price risk" would introduce an element of subjectivity that would make a federal position limit framework difficult, if not impossible, to administer**.[207]

The CFTC is correct. Unfortunately, even with this eminently reasonable observation, it also stresses that it may consider non-price risk management transactions as part of the evaluation process associated with non-enumerated hedging requests. The CFTC need not, and should not, walk back its principled stance on price risks. Good policy often requires hard and unpopular decisions, and this is one of them. The CFTC must retain the word "price" in Proposed § 150.1 and clarify that the term "commercial enterprise" captures solely transaction or position that would be directly and demonstrably risk reducing to "cash or spot operations" for physical commodities underlying contracts for which the person seeks to rely upon the bona fide hedging definition. That would render the Incidental Test unnecessary.[208] In this regard, the CFTC's proposed elimination of the Incidental Test—which currently requires hedges to "have a purpose to offset ***price*** risks incidental to commercial cash or spot operations"[209]—must be accompanied by the proposed definitive emphasis on "price."

Pass-Through Swaps Exemption

CEA section 4a(c)(2)(B)(i) recognizes as a bona fide hedging position any position that "reduces risks attendant to a position resulting from a swap that . . . was executed opposite a counterparty for which the transaction would qualify as a bona fide hedging transaction" pursuant to 4a(c)(2)(A).[210] In addition, CEA section 4a(c)(2)(B)(ii) recognizes as a bona fide hedging position any position that "reduces risks attendant to a position resulting from a swap that . . . meets the requirements" of 4a(c)(2)(A).[211] The CFTC

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207 Id at 11606.

208 The statutory amendments by the Dodd-Frank Act did not include a requirement that bona fide hedging transactions or positions be established and liquidated in an orderly manner in accordance with sound commercial practice. **However, the CFTC should not delete a common sense condition with respect to a key regulatory exemption. We therefore recommend that the CFTC restore it in the final rulemaking**.

209 17 C.F.R. § 1.3. CFTC, Position Limits for Derivatives, 85 Fed. Reg. 11596, 11604 (Feb. 27, 2020).

210 7 U.S.C. § 6a(c)(2)(B)(i).

211 7 U.S.C. § 6a(c)(2)(B)(ii).

proposes to codify these provisions. The primary "practical effect" of "conforming the temporary substitute test in the regulation to the amended statutory provision [therefore] would be to prevent market participants from treating positions entered into for risk management purposes as bona fide hedges for contracts subject to federal limits, **unless the position qualifies under the pass-through swap provision** in CEA section 4a(c)(2)(B)."[212] The scope of the CEA's pass-through swap provisions and accompanying regulations therefore are critical to understanding the impact of the proposed elimination of the risk management exemption.

Pursuant to the pass-through swap exemption, swaps dealing activities, including swaps or other positions hedging swaps dealing transactions with bona fide hedgers, essentially inherit the bona fide hedging status of the swaps arising from physical commodities exposures. In this sense, the hedging counterparty's inventory of physical commodities might be thought of as *passing through* to the swap dealer or other liquidity provider, which was Congress' means for "prohibit[ing] risk management positions that are not opposite a bona fide hedging swap counterparty,"[213] while ensuring that liquidity would not be diminished by position limits

The scope of the proposed pass-through swaps provision turns on the bona fide hedging transactions or positions definition. If that definition is defined too broadly, the pass-through exemption may be tantamount to a categorical exemption from position limits for swap dealers ostensibly accommodating hedgers. This could be true, moreover, where the dealing-related hedges that are not directly accommodating the hedging counterparty create exposures in Referenced Contracts for which the dealer routinely does not take delivery. The due diligence involved in ensuring dealers appropriately rely upon the pass-through exemption are unlikely to involve significantly more receiving template counterparty representations that relevant transactions qualify as bona fide hedging transactions or positions.[214]

Thus, although we are fully supportive of the CFTC's elimination of the risk management exemption, that positive development would mean little practically if the CFTC does not revise, reconsider, and/or withdraw other aggressively permissive provisions of the proposal, including the high federal spot month position limits and the lack of non-spot month limits. In addition, significant effects in Core Referenced Futures Contracts could arise from the combination of the pass-through swaps exemption and the bona fide hedging transactions and positions substantially expanded in the proposal. In short, the pass-through swaps exemption risks morphing into a categorical dealer exemption over time on account of the clear expansion of the CFTC's conception of "hedging." That risk would essentially nullify positive effects from revocation of the risk management exemption.

The CFTC's Further Interpretations and Implementation of the Bona Fide Hedging Definition

The exemption for bona fide hedging transactions or positions includes Proposed § 150.3 exemptions for enumerated and non-enumerated hedging. The enumerated exemptions for bona fide hedging transactions or positions are proposed to be included in Appendix A to part 150 and would be self-effectuating (i.e., they would not require CFTC recognition), while the non-enumerated exemptions potentially meeting the definition of bona fide hedging transactions or positions but not included in Appendix A must be approved by exchanges and deemed recognized by the CFTC in accordance with

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212 CFTC, Position Limits for Derivatives, 85 Fed. Reg. 11596, 11605, fn. 56 (Feb. 27, 2020) (emphasis added).

213 Id at 11614.

214 See Proposed § 150.3(d)(2).

Proposed § 150.3(b)(4)[215] or Proposed § 150.9.[216] Because speculation is effectively defined by exemption, the scope, precision, and clarity of exemptions further interpreting defined terms, like "bona fide hedging transactions or positions," are critical.[217] **Any definitional exclusions or exemptions therefore must be conservatively and narrowly drafted to ensure that the CFTC's conception of "excessive speculation" captures all speculative activities.**

The sole purpose of the derivatives markets on physical commodities is to enable commercial participants to legitimately hedge risks and thereby mitigate intrinsic uncertainties involved in commodities production and consumption. Speculation therefore can be viewed as merely "tolerated" to the extent that it supports this fundamental purpose. That is why the proposal, like others before it, essentially presumes that trading is speculative for purposes of position limits unless the trader can rely upon a hedging or other exemption. That, of course, require careful consideration of the scope of such exemptions. Permitting hedging that is in the nature of speculation would be equivocation and not only intellectually dishonest but also a fundamentally contrary to Congress' statutory concerns about the potential for excessive speculation to undermine the integrity and stability of the physical commodity derivatives markets and their critical risk management purposes.

1. The proposed expansion of self-effectuating enumerated hedging transactions in Appendix A wrongly would exempt most transactions taken solely in anticipation of future underlying commodity exposures.

The CFTC proposes enumerated bona fide hedging exemptions that too broadly accommodate trading practices that are not risk reducing. For Referenced Contracts under 150.2(d),[218] any trader that holds a bona fide hedging transaction or position in Referenced Contracts and whose hedging is included in the list of self-effectuating enumerated hedges in proposed Appendix A to part 150 would not be required to seek further CFTC recognition to exceed limits on applicable positions. However, such trader would be required to request recognition (approval) of the enumerated hedge from the listing exchange for purposes of that exchange's limits.[219]

The CFTC emphasizes that the proposed enumerated hedges, including the anticipatory hedging recognitions, "represent[] just one way, but not the only way, to satisfy the proposed bona fide hedging definition and [Proposed] § 150.3(a)(1)."[220] However, the CFTC's proposed expansion of enumerated

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215 See Proposed § 150.9.

216 The CFTC does not, by regulation, routinely collect all information necessary to oversee these existing exemptions. However, CFTC § 150.3(b) provides that the CFTC (or its staff) may make special calls from those relying on one or more of the position limits exemptions, and such calls may include derivatives position information, trading data, and physical positions that support the claimed exemption. In addition, the CFTC receives pertinent information from part 17 reported data, the monthly Form 204, and information from designated contract markets.

217 The CFTC proposes a new bona fide hedging definition in. § 150.1 and a new process for recognizing non-enumerated bona fide hedging positions in proposed § 150.9. Currently, § 150.3(a) provides an exemption for positions that may, under certain circumstances, exceed federal limits. 17 C.F.R. § 150.3(a). The two exemptive categories are as follows: (1) bona fide hedging transactions, as defined in § 1.3, including transactions for which the CFTC has granted recognitions for enumerated anticipatory positions pursuant to § 1.48, 17 C.F.R. § 1.48, .and non-enumerated hedges pursuant to § 1.47; 17 C.F.R. § 1.47, and identified types of spread or arbitrage positions. Persons owning or controlling positions must apply for recognition of bona fide hedging transactions or positions in advance, while spread exemptions are self-effectuating with respect to nine agricultural contracts.

218 Table 1 to Proposed § 150.2(d) lists 25 Core Referenced Futures Contracts subject to federal position limits, which would be published in Appendix E to part 150 as referenced in Proposed § 150.2(e).

219 See 17 C.F.R. § 1250.5(a).

220 Id.

hedging recognitions is expected to be sweeping. The CFTC tellingly comments that the market's use of the *non-enumerated* hedging recognitions process in Proposed 150.9 would be "rare and exceptional."[221] **That is an acknowledgement that the CFTC's enumerated hedges permit such a broad scope of self-effectuating hedging recognitions that the non-enumerated hedging recognitions process would be just short of a formality**.

The CFTC claims that the proposed enumerated hedges in proposed Appendix A would be reserved for the types of bona fide hedging transactions or positions that do not require "further consideration as to the particulars of the case."[222] In other words, the proposed enumerated hedges would "reflect fact patterns for which the [CFTC] has preliminarily determined, based on experience over time, that no case-by-case determination, or review of additional details, by the [CFTC] is needed to determine that the position or transactions is a bona fide hedge."[223] The CFTC is apparently comforted by the fact that enumerated hedging exemptions would continue to be subject to exchange approvals, and the CFTC's "close oversight" of exchanges that would permit it to confirm cash market positions that form the basis of each trader's reliance on the exemption.

This is, yet again, a delegation of the CFTC's responsibilities for overseeing federal position limits to for-profit exchanges with conflicts of interest (discussed above). However, if Congress deemed exchange policing of excess speculation in this manner to be sufficient, there would be little, if any, need for the extensive federal position limits framework mandated by the CEA. Consider the list of eleven enumerated hedges provided in proposed Appendix A, five of which would be new enumerated exemptions:

Self-Effectuating Enumerated Hedges in Proposed Appendix A

Hedging Strategy	
Hedges of unsold anticipated production.	Hedges of inventory and cash commodity fixed-price purchase contacts.
Hedges of offsetting unfixed-price cash commodity sales and purchases.	Hedges of cash commodity fixed-price sales contracts.
Hedges of anticipated royalties.*	Hedges by agents.*
Hedges of services.*	Offsets of commodity trade options.*
Cross-commodity hedges.	Hedges of unfilled anticipated requirements.
Hedges of anticipated merchandising.*	

* Denotes new proposed enumerated hedges. Source: CFTC Proposal[224]

221 CFTC, Position Limits for Derivatives, 85 Fed. Reg. 11596, 11650 (Feb. 27, 2020).

222 Id at 11607.

223 Id.

224 Id at 11600.

The CFTC proposes to substantially expand (almost triple) the number of self-effectuating enumerated bona fide hedges, which include recognitions for various forms of anticipatory hedging. Anticipatory hedges involve directional transactions meant to hedge risks expected within a reasonably proximate period of time but that do not exist when the hedge is executed. Thus, some so-called anticipatory "hedging" is not really hedging at all. But where the potential scope of "expected" or "anticipated" risk is sweeping (as it is for certain dealers involved in the physical markets but that *also* have active trading desks), it would be essentially impossible for the CFTC and exchanges to monitor and enforce position limits tied in some legally cognizable way to physical commodities transactions. The nature of trading by such firms is further obscured by portfolio and dynamic hedging and hedging that occur across legal entities or business lines and trading desks.

Accordingly, numerous elements of the proposed enumerated hedging transactions or positions would facilitate avoidance for the commercial firms perhaps most likely to engage in substantial speculative trading. We agree that the CFTC must reasonably consider the legitimate hedging needs of firms involved in the physical commodities markets, including legitimate practices in the energy and metals markets. However, **the CFTC must be exceedingly cautious in adopting new and expansive enumerated bona fide hedging transactions or positions intended to accommodate a broad array of physical markets and hedging activities, while opening the door to self-executing exemptions that might include trading activities that are speculative**.

Indeed, the potential for abuse of a self-effectuating, deferential enumerated hedges is apparent. Thus, although we acknowledge value in *some* legitimately risk reducing, properly confined anticipatory hedging activities, the CFTC must rely upon the appropriately fact-specific, hedge-specific, and firm-specific process governing non-enumerated hedges in those cases where the potential for abuse is especially acute (e.g., with respect to self-effectuating exemptions proposed for anticipatory merchandizing). That would permit the CFTC to weigh the merits of a proposed hedging strategy and request cash-markets data as necessary to confirm the legitimacy of the hedge and represented information. **In other words, the CFTC must adopt conservative enumerated hedges that very well may exclude legitimate hedging activities from the self-effectuating, minimally reviewed enumerated hedging category, especially with respect to "anticipated hedges" that raise very serious concerns about avoidance and evasion**. This does not preclude, of course, consideration of a sufficiently thorough non-enumerated hedging recognitions process.

In this regard, consider our continuing concerns relating to the hedging of anticipated price risks, which make monitoring and enforcement of the self-effectuating hedges all but impossible:

- **Hedges of Unsold Anticipated Production:** The CFTC proposes to maintain the existing hedge for unsold anticipated production, which we view as reasonably confined and appropriate. This particular hedge would "allow a market participant who anticipates production, but who has not yet produced anything, to enter into a short derivatives position in excess of limits to hedge the anticipated production."[225] Practically, we agree that some pre-hedging of known, specific, and certain production occurring in the very near future—and which reflects a longstanding business practice for a firm involved in the physical commodities markets—facilitates production by permitting firms to lock-in margins on the production of physical commodities. **Our concern, however, is that the CFTC proposes new language that would remove the 12-month limitation on unsold anticipated production**, permitting directional derivatives trading that can be characterized as "anticipated hedging" for production

[225] CFTC, Position Limits for Derivatives, 85 Fed. Reg. 11596, 11608 (Feb. 27, 2020).

that would not occur for years into the future. That transforms a previously reasonable and reasonably verifiable enumerated hedge into a loophole, and the CFTC must therefore reinstate the 12-month limitation.

- **Hedges of Anticipated Services**:[226] The CFTC proposes a new enumerated hedge relating to anticipated services. The new hedge would recognize "a long or short derivatives position used to hedge the anticipated change in value of receipts or payments due or expected to be due under an executed contract for services arising out of the production, manufacturing, processing, use, or transportation of the commodity underlying the commodity derivative contract."[227] As above with respect to the enumerated hedge of unsold anticipated production, we are concerned about the potential for the enumerated hedge of anticipated services to be abused without some time limitation to complement the already ambiguous required nexus of the hedge to an executed contract.

- **Cross-Commodity Hedges**:[228] The CFTC proposes to expand the application of the enumerated cross-commodity hedging provisions to all enumerated hedges (as well as the pass-through swaps provisions discussed below), which would have the effect of broadly excluding from position limits those derivatives in commodities that bear a "reasonable commercial relationship" to other commodities that a firm seeks to offset on account of cash purchases or sales, or both. We again view some cross-commodity hedges as appropriate, normal, and legitimate market practices. We would not, in principle, object to a properly confined exclusion, because some types of physical commodities exposures can be practically and most efficiently risk managed only through contracts on related commodities. Our concern, again, is abuse of the self-executing enumerated hedge without additional standards to limit what constitutes a reasonable proxy for the physical commodity posing price risks to the firm. In retaining the cross-commodity hedge, **the CFTC must require that reliance on the self-executing, enumerated cross-commodity hedge turn on a "demonstrable price relationship between the commodity underlying the derivatives transaction or position for which a person relies upon the cross-commodity enumerated hedge treatment and the commodity giving rise to the price risk to such person.**"

- **Hedges of Unfilled Anticipated Requirements**:[229] The CFTC proposes to modify the existing enumerated hedges for unfilled anticipated requirements. The modified hedge would treat as a bona fide hedge "a long position in a commodity derivatives contract to offset the expected price risks associated with the anticipated future purchase of the cash-market commodity underlying the commodity derivative contract."[230] Like the other anticipated hedging categories, the potential use and abuse of this enumerated hedge is evident. With respect to the

226 Id at 11609 (emphasis added).

227 Id.

228 Id

229 Id at 11610.

230 Id.

latter, we are concerned that the CFTC proposes to eliminate the 12-month unfilled anticipated requirements beyond the spot period. That again transforms a previously reasonable and reasonably verifiable enumerated hedge into a loophole. The CFTC must therefore reinstate the 12-month limitation.

All of these issues demand the CFTC attention. However, perhaps most concerningly, the CFTC proposes to recognize a new self-effectuating bona fide hedging exemption for anticipated merchandizing. The enumerated hedge would permit a merchant to "establish a long or short position in a commodity derivative contract to offset the anticipated change in value of the underlying commodity that the merchant anticipates purchasing or selling in the future."[231]

The new exemption would be conditioned on the position not exceeding 12 months' of the quantity of anticipated merchandising needs (purchase or sale requirements) of the same commodity that is anticipated to be merchandized. This condition and others,[232] unlike the eliminated time limitation requirements associated with similar enumerated hedging exemptions, acknowledges the importance of "**calibrating the anticipated need within a reasonable timeframe and the limitations in physical commodity markets, such as annual production or processing capacity**," in particular where hedging is "**based on anticipated activity on yet-to-be established cash positions due to the uncertainty of forecasting such activity and, all else being equal, the increased risk of excessive speculation on the price of a commodity the longer the time period before the actual need arises**."[233] While the CFTC rightly distinguishes this enumerated exemption from similar types of anticipated hedging, an identical conceptual avoidance risk continues to exist across all of these anticipatory hedges—namely, that firms may claim an underlying risk is anticipated in order to justify positions well over the speculative limits in Referenced Contracts.

Cash Market Reporting

The scope of these enumerated hedges is even more problematic, because the CFTC proposes to eliminate forms market participants with bona fide hedging positions in excess of position limits "currently file each month with the [CFTC] to demonstrate cash-market positions justifying such overages."[234] The CFTC proposes, instead, to require exchanges to collect, and provide to the CFTC upon request, relevant cash-market information. This is inadvisable. First, while rule enforcement reviews would continue to reasonably ensure that exchanges take disciplinary and enforcement actions consistent with their own rulebooks, the lack of a Form 204 and related cash-market forms and information eliminates the substantial deterrence to misreporting associated with potential violations of federal law. Accordingly, the proposal would eliminate the CFTC's access to routine hedging-related information and raise unnecessary hurdles to monitoring and enforcement of verifiable information provided under penalty of law. Second, the proposed elimination of cash positions reporting perversely would balkanize reporting and increase the industry's overall reporting burdens, because CFTC forms would be replaced by an exchange-by-exchange reporting framework.

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231 Id.

232 The CFTC also conditions reliance on the anticipatory merchandizing exemption on an actual merchandizer being involved in the applicable transaction. The person claiming the exemption must be a merchant who can demonstrate that purchasing and selling the underlying commodity that is anticipated to be merchandised is a historical practice (or otherwise demonstrate activities in the physical marketing channel), and it must have "a history of making and taking delivery of the underlying commodity, and a demonstration of an ability to store and move the underlying commodity." Id at 1611.

233 Id.

234 Id at 11598.

The CFTC proposes to replace that reporting framework with standards applicable to applications for reliance on enumerated hedges at exchanges. The CFTC explains as follows:

> Exemption applications filed with an exchange include sufficient information to enable the exchange to determine, and the [CFTC] to verify, whether the exchange may grant the exemption, including an indication of whether the position qualifies as an enumerated hedge for purposes of federal limits and a description of the applicant's activity in the underlying cash markets; and that the exchange provides the [CFTC] with a monthly report showing the disposition of all exemption applications, including cash market information justifying the exemption.[235]

The CFTC should finalize precisely the opposite. It should ensure that all cash positions reporting is automated, reliable, comprehensive, electronic, and amenable to aggregation. It can then provide cash reporting to the exchanges.

Permissible Gross Hedging

The CFTC proposes to permit gross hedging, reversing a longstanding preference for net hedging largely concerned with avoidance, if not evasion, of the position limits framework. Specifically, the CFTC proposes broader discretion for market participants to recognize as bona fide "gross hedging," which contravenes a "longstanding preference" that "has been underpinned by a concern that unfettered recognition of gross hedging could potentially allow for the cherry picking of positions in a manner that subverts the position limits rules."[236]

The CFTC itself provides a useful and concise demonstration that fully captures our concerns about the danger of facilitating gross hedging:

> [U]sing gross hedging, a market participant could potentially point to a large long cash position as justification for a bona fide hedge, even though the participant, or an entity with which the participant is required to aggregate, has an equally large short cash position that would result in the participant having no net price risk to hedge as the participant had no price risk exposure to the commodity prior to establishing such derivative position. Instead, the participant created price risk exposure to the commodity by establishing the derivative position.[237]

In short, gross hedging may be used to conduct an end run around the position limits regulations, especially by the largest multi-business-line firms involved in the physical markets and perhaps most likely to rely on exceedances for such bona fide hedging positions.

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235 Id at 11611.

236 Id at 11613.

237 Id at 11613, fn. 115. The CFTC requires some conditions, however, namely, the following: (1) "the manner in which the person measures risk is consistent over time and follows a person's regular, historical practice (meaning the person is not switching between net hedging and gross hedging on a selective basis simply to justify an increase in the size of his/her derivatives positions)," Id at 11613, and the person is able to demonstrate as much to the CFTC and/or an exchange upon request; (2) "the person is not measuring risk on a gross basis to evade the limits set forth in proposed s 150.2 and/or the aggregation rules currently set forth in s 150.4," Id at 11601, and the person is able to demonstrate as much to the CFTC and/or an exchange upon request; and (3) "an exchange that recognizes a particular gross hedging position as a bona fide hedge pursuant to proposed § 150.9 documents the justifications for doing so and maintains records of such justifications in accordance with proposed § 150.9(d)." Id.

Orderly Trading Pursuant to the 5-Day Rule

The CFTC proposes to eliminate a restriction on continuing to hold enumerated bona fide hedging positions in excess of federal position limits "during the last five days of the spot period (or during the spot period . . . if less than five days)."[238] For enumerated hedges in Referenced Contracts, this elimination of the "five-day rule" would permit market participants to maintain bona fide hedge positions during the last five trading days of the spot period, unless the listing exchange determines, in its discretion, to impose such a restriction. The CFTC proposes minimal guidance that would set forth circumstances in which an enumerated bona fide hedging transactions or positions may continue to be held as contracts approach expiry.

Remarkably, while proposing to eliminate the five-day rule, the CFTC acknowledges its utility:

> The [CFTC] has viewed the five-day rule as an important way **to help ensure that futures and cash-market prices converge and to prevent excessive speculation as a physical-delivery contract nears expiration, thereby protecting the integrity of the delivery process and the price discovery function of the market, and deterring or preventing types of market manipulations such as corners and squeezes**. The enumerated hedges currently subject to the five-day rule are either: (i) Anticipatory in nature; or (ii) involve a situation where there is no need to make or take delivery. The [CFTC] has historically questioned the need for such positions in excess of limits to be held into the spot period if the participant has no immediate plans and/or need to make or take delivery in the few remaining days of the spot period.[239]

Nevertheless, the CFTC proposes to abolish the rule for enumerated hedges, over-relying instead—and again—on the judgment of the exchanges to determine whether to apply the five-day rule, or apply and grant fact-specific waivers, or "whether to apply other tools that may be equally effective."[240]

Although other tools, like step-down limits applied to numerous contracts, may benefit price discovery and convergence, the CFTC need not permit one in lieu of the other. Exchanges can and should, indeed must, adopt rules that protect the integrity of markets on physical commodities, and they undoubtedly would continue doing so if the five-day rule were retained. Moreover, the CFTC not only explicitly acknowledges the "valid" policy reasons for the five-day rule but also implicitly acknowledges the potential for disruptive practices in the absence of the rule, emphasizing that it "expects that exchanges would closely scrutinize any participant who requests a recognition . . . ."[241]

If the CFTC finalizes its proposed elimination of the five-day rule (and it should not), the CFTC must at least adopt its guidance as a formal waiver process, which would treat the many reasonable discretionary factors in the guidance under a rules-based regime for providing exceptions from the five-day rule. For example, the CFTC in such case should require an "economically appropriate" need to maintain such position relating to a cash commodity in excess of federal speculative position limits during the spot period. It also should codify the following elements of the guidance:

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238 Id at 11601.

239 Id at 11612.

240 Id.

241 Id.

> [T]he person wishing to exceed federal position limits during the spot period: (1) Intends to make or take delivery during that period; (2) provides materials to the exchange supporting the waiver of the five-day rule; (3) demonstrates supporting cash-market exposure in-hand that is verified by the exchange; (4) demonstrates that, for short positions, the delivery is feasible, meaning that the person has the ability to deliver against the short position; and (5) demonstrates that, for long positions, the delivery is feasible, meaning that the person has the ability to take delivery at levels that are economically appropriate.[242]

Elevating such "considerations" to regulatory factors at least ensure that the exchanges abide by the letter of these reasonable conditions.

2. The non-enumerated hedging recognitions process defers too significantly to exchanges to grant recognitions and practically eliminates CFTC oversight.

Proposed § 150.3(a)(1)(ii) would permit market participants to request exemptions from federal position limits for bona fide hedges that are not enumerated in proposed Appendix A to Part 150.[243] These requests for recognition of non-enumerated hedges would not be self-effectuating. Rather, market participants would be required to demonstrate that they meet the definition of a bona fide hedging transactions or positions in an application either (1) to the CFTC and the exchange listing or facilitating trading in the contract,[244] or (2) solely to the exchange delegated authority to approve such applications from both federal and exchange limits.[245] Most relevantly, exchanges would be required to concurrently notify the CFTC and applicants of their determinations relating to the latter process for submitting non-enumerated hedging applications.[246] Upon "issuance" of such notification, the CFTC would have a 10-day review period modeled on the part 40 rule-filing process during which the CFTC can issue an objection notification or issue a stay notification.[247] However, if the CFTC does not object or issue such stay by the review period's expiration, the non-enumerated hedging recognition request would be deemed approved for purposes of federal and exchange position limits.[248]

In addition, the CFTC proposes to permit exchanges to adopt a lenient cure period for violations of position limits. Market participants ordinarily must receive a non-enumerated hedge exemption determination prior to exceeding any position limit. However, the CFTC proposes a retroactive position

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242 Id at 11612-13.

243 17 C.F.R. § 1.3 (permitting market participants to recognize non-enumerated bona fide hedging transactions and positions pursuant to a request using the process in § 1.47).

244 See Proposed § 150.3(b) and Proposed § 150.5(a).

245 See Proposed § 150.9. See also CFTC, Position Limits for Derivatives, 85 Fed. Reg. 11596, 11601, 11638 (Feb. 27, 2020). The CFTC proposes that request for non-enumerated hedges would include the following: (i) A description of the position in the commodity derivative contract for which the application is submitted, including the name of the underlying commodity and the position size; (ii) information to demonstrate why the position satisfies CEA section 4a(c)(2) and the definition of bona fide hedging transaction or position in proposed § 150.1, including factual and legal analysis; (iii) a statement concerning the maximum size of all gross positions in derivative contracts for which the application is submitted (in order to provide a view of the true footprint of the position in the market); (iv) information regarding the applicant's activity in the cash markets and the swaps markets for the commodity underlying the position for which the application is submitted; 269 and (v) any other information that may help the Commission determine whether the position meets the requirements of CEA section 4a(c)(2) and the definition of bona fide hedging transaction or position in § 150.1.

246 Proposed § 150.9(e).

247 Proposed § 150.9(e)(3). See also Proposed § 150.9(e)(5).

248 Id.

limit exceedance process for circumstances in which a market participant violates a position limit due to "sudden or unexpected" increases in bona fide hedging needs.[249] Remarkably, even if the CFTC miraculously would able to issue the proposed objection notification, the market participant would not be subject to a position limit violation if it reduces the position in a "commercially reasonable amount of time."[250]

The 10-day review period is practically impossible for the CFTC to meet. While the proposal requires a mere objection "notification" within the regulatory review period, the proposal also requires formal CFTC action (and explicitly emphasizes that CFTC staff action would be insufficient[251]) to prevent the hedging exemption from being deemed approved. That, we presume, requires the CFTC staff to review incoming information, await a response from market participants or exchanges, consider the information, draft a reversal memo and draft order for CFTC consideration, receive the CFTC chairman's approval for seriatim circulation, and then complete a seriatim process in which CFTC commissioners would have limited opportunity to inquire about the application, determine how to vote, and consider a written statement. Furthermore, **the exceedance cure process is beyond impractical and amounts to an outright tolerance level for position limits violations.** Thus, while we directionally approve of the CFTC's determination to include the CFTC in the non-enumerated hedging determinations by exchanges relative to the 2016 proposal, the CFTC would have an exceedingly minimal role and too little practical oversight of exchange determinations.

Moreover, the standards intended to constrain discretion of the exchanges are hardly a meaningful constraint. The proposal, is essence, asks exchanges to "**take into account** (i) [w]hether the requested [non-enumerated] exemption from its limits would result in a position that is 'not in accord with sound commercial practices' in the market for which the [DCM] is granting the application;[252] **and/or** (2) [w]hether the requested exemption would 'exceed an amount that may be established or liquidated in an orderly fashion in that market.'"[253] **Under such flexible and sweeping standards, there is no doubt that the CFTC correctly characterizes its proposal in this respect as "afford[ing] exchanges the ability to generally oversee their programs for granting exemptions from exchange limits as they see fit,"[254] with minimal oversight.**

249 Proposed § 150.9(e)(4).

250 Id at 11653.

251 CFTC, Position Limits for Derivatives, 85 Fed. Reg. 11596, 11602 (Feb. 27, 2020).

252 To be sure, the CFTC does clarify that "activity with manipulative intent or effect, or that has the potential or effect of causing price distortion or disruption, would be inconsistent with 'sound commercial practice,' even if common practice among market participants." Id at 11645. In addition, the CFTC rightly emphasizes that it expects exchanges to consider "whether the granting of a particular exemption type to multiple participants could have a collective impact on the market in a manner inconsistent with 'sound commercial practice' or in a manner that would 'exceed an amount that may be established or liquidated in an orderly fashion in that market.'" Id.

253 Id at 11600, 11645 (emphasis added).

254 Id.

V. The CFTC's proposed interpretation that the CEA requires a "necessity" finding in connection with imposition of federal position limits is inconsistent with a plain reading of the CEA's position limits mandate, reverses longstanding views at the agency, raises unnecessary administrative hurdles, and opens avenues for legal challenge.

Section 737(a)(4) of the Dodd-Frank Act codified new CEA section 4a(a)(2)(A), which provides that the CFTC "shall establish position limits for contracts in physical commodities other than excluded commodities "[i]n accordance with the standards set forth in" CEA section 4a(a)(1). That latter section provides, in turn, that the CFTC shall establish position limits as it "finds are necessary to diminish, eliminate, or prevent" the "undue and unnecessary burden on interstate commerce" associated with "[e]xcessive speculation in any commodity under [futures] contracts . . . or swaps that perform or affect a significant price discovery function . . . causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity."[255]

The CFTC finalized a position limits regulation in 2011 that implemented this statutory mandate to expand the existing framework for DCM-listed physical commodities futures contracts. In issuing an order vacating most elements of the CFTC's 2011 position limits release, however, the U.S. District Court for the District of Columbia instructed the CFTC to "determine, in light of the [CFTC]'s 'experience and expertise' and the 'competing interests at stake,' ***whether*** section 4a(a)(2)(A) requires the [CFTC] to make a necessity finding before establishing the relevant limits, or if section 4a(a)(2)(A) is a mandate from Congress to do so without that antecedent finding."[256]

In applying the CFTC's administrative expertise, Better Markets encourages the CFTC to adopt the well-reasoned, well-written, and well-researched legal views of U.S. Senators that took the extraordinary step of filing a 26-page amicus brief supporting of the CFTC own position on necessity findings in Int'l Swaps & Derivatives Ass'n v. U.S. Commodity Futures Trading Commission.[257] **Rather than restate the lengthy legal arguments here, we incorporate the amicus brief in the present administrative record.** We remind the CFTC that numerous, if not all, signatories to that amicus brief voted for statutory changes effectuated by the Dodd-Frank Act and sponsored and voted specifically for CEA amendments implemented by section 737 of the Dodd-Frank Act.

VI. Conclusion

Position limits undoubtedly have been a challenging 10-year regulatory endeavor, in part because they require calibration of thresholds that balance competing policy objectives. On the one hand, some limited amount of speculation is viewed as necessary to providing sufficient liquidity and accommodation of risks for bona fide hedgers, which, in many markets, do not naturally have offsetting trading interests in the long and short side of the markets. On the other hand, excessive speculation—which is speculation that does not provide necessary liquidity or facilitate risk management for such bona fide hedgers—undermines price discovery and efficient risk management, thereby reducing the public interest purposes of the derivatives markets.

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255 7 U.S.C. § 6a(a)(1).

256 CFTC, Position Limits for Derivatives, 85 Fed. Reg. 11596, 11658 (Feb. 27, 2020).

257 Brief for Senators Levin et al. as amici curiae in support of defendant Commodity Futures Trading Commission, International Swaps and Derivatives Association et al. v. Commodity Futures Trading Commission, Civil Action No. 1:11-CV-2146-RLW (Apr. 13, 2012), available at https://www.blumenthal.senate.gov/imo/media/doc/Amicus%20Brief%20on%20position%20limits%204%2013%2012.pdf.

The CFTC's newest proposal acknowledges the urgent need to implement the CEA's statutory directives to limit excessive speculation. However, it again falls substantially short of accomplishing the intended goal of restoring a stable, functional derivatives market on physical commodities that operates to the benefit of physical commodity producers and consumers, including working Americans and the world's poor that ultimately bear the costs of distortions in the markets. As it has in the series of proposals dating back to at least 2011, the CFTC has added exclusions, conditions, and exemptions that diminish the proposal's effectiveness in preventing excessive speculation.

The proposal again seeks to establish position limits that in many cases are so high, and so narrowly applied, that they would fail to meaningfully prevent or reduce excessive speculation outside of the most egregious and patently unlawful cases of manipulation. They would fail to capture particularly harmful types of speculation, including trading by ETFs and similar commodity index funds, despite the facts that Congress authorized the CFTC to place limits on any "group or class of traders"[258] and that fees, distortions, and inefficiencies associated with the considerable positions held by such entities come largely, if not entirely, from the pockets of the investors and those hurt by their presence in the markets.

To make matters worse, the proposal impermissibly reduces the CFTC's ability to reasonably limit excessive speculation by delegating paramount duties and authorities to a handful of DCMs (many of which are under common control). The deficiencies associated with the proposed undue deference to exchanges in establishing position limits, in particular, should be obvious, because such exchanges operate with conflicts of interest that have been attendant to demutualization and the transition to a for-profit business model over two decades.

Better Markets appreciates the opportunity to comment on the CFTC's proposed position limits framework. The CFTC emphasizes in its release that "[b]ecause the earlier proposals [have been] withdrawn, comments on them will not be part of administrative record with respect to the current proposal, except where expressly referenced . . . ."[259] **For this reason, we hereby incorporate our pertinent comments to previous CFTC position limits proposals, which we hope will inform the CFTC's deliberations**.[260] In addition, other public interest groups, academics, and commodity producers and end-

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258 See 7 U.S.C. § 6a(a)(1) (providing that the CFTC "shall . . . fix such limits on the amounts of trading which may done or positions which may be held by any person, including any group or class of traders . . . as the [CFTC] finds are necessary to diminish, eliminate, or prevent" the "undue and unnecessary burden on interstate commerce" caused by "excessive speculation in any commodity").

259 CFTC, Position Limits for Derivatives, 85 Fed. Reg. 11596, 11597, fn. 15 (Feb. 27, 2020).

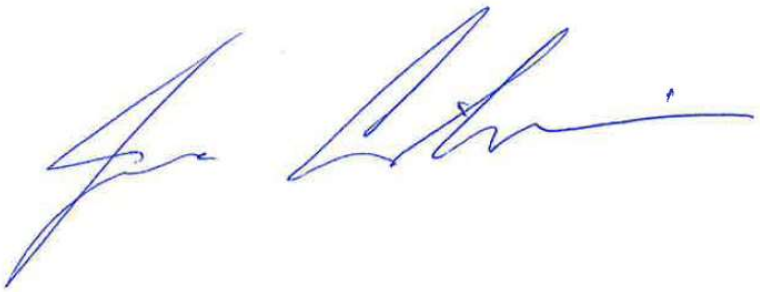
260 **Better Markets would like to incorporate the following comment letters into the administrative record for the present proposal, which raise a number of additional pertinent issues not discussed above and provide addition information relating to a number of issues that are discussed above**: Better Markets, Position Limits for Derivatives (CFTC RIN: 3038-AD99) (Feb. 28, 2017), available at https://bettermarkets.com/sites/default/files/CFTC-%20CL-%20Position%20Limits%20for%20Derivatives-%2020170228.pdf; Better Markets, Position Limits for Derivatives: Certain Exemptions and Guidance (CFTC RIN: 3038AD99) (July 13, 2016), available at https://bettermarkets.com/sites/default/files/CL%20-%20CFTC%20-%20Position%20Limits%20for%20Derivatives%20Certain%20Exemptions%20and%20Guidance%20-%207-13-2016.pdf; Better Markets, Position Limits for Derivatives and Aggregation of Positions (CFTC RIN 3038-AD99, 3038-AD82) (Mar. 30, 2015), available at https://bettermarkets.com/sites/default/files/CFTC%20-%20CL%20-%20Position%20Limits%20for%20Derivatives%20and%20Aggregation%20of%20Positions%20-%203-30-2015.pdf; Better Markets, Position Limits for Derivatives and Aggregation of Positions (RIN 3038-AD99; 3038-AD82) (Jan. 22, 2015), available at https://bettermarkets.com/sites/default/files/CFTC%20-%20CL-%20Position%20Limits%20for%20Derivatives%20and%20Aggregation%20of%20Positions%20-%201-22-2015.pdf; Better Markets, Position Limits for Derivatives (CFTC RIN 3038-AD99) (Feb. 10, 2014), available at https://bettermarkets.com/sites/default/files/CFTC-%20CL-%20Position%20Limits-%202-10-14-%20Final.pdf; Better Markets, Position Limits for Futures and Swaps (CFTC RIN 3038-AD17) (Jan. 17, 2012), available at

users have provided much thoughtful input on an array of issues arising from and related to the proposal that must be considered whether or not formal submission of this useful diversity of viewpoints is re-submitted into the administrative record for the present proposal, in particular as the CFTC has determined not to toll or extend comment periods in a manner that permits meaningful, comprehensive public comment on account of the ongoing COVID-19 pandemic.[261]

In this regard, there are numerous issues we would have preferred to comprehensively, thoughtfully, and more empirically address in this comment letter. That is not possible under the circumstances.

Nevertheless, we hope our comments are helpful.

Sincerely,



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https://bettermarkets.com/sites/default/files/CFTC-%20CL-%20Position%20Limits%20IFR-%201-17-12.pdf; Better Markets, Position Limits for Futures and Swaps (CFTC RIN 3038-AD17) (Jan. 13, 2012), available at https://bettermarkets.com/sites/default/files/CFTC-%20CL-%20Position%20Limits%20IFR-%201-13-12.pdf; and Better Markets, Position Limits for Derivatives (CFTC RIN 3038-AD15 and 3038-AD16) (Mar. 28, 2011), available at https://bettermarkets.com/sites/default/files/documents/CFTC%20Position%20Limits%20CL%20As%20Submitted%20Hi%20Res.pdf.

[261] Better Markets Letter to CFTC Chairman Heath P. Tarbert, Re: Tolling of Public Comment Periods for Pending CFTC Regulatory Actions (Apr. 1, 2020), available at https://bettermarkets.com/sites/default/files/documents/Better_Markets_Letter_to_Chairman_Talbert_Regarding_Tolling_of_Public_Comment_Periods.pdf.