

From: Rob Underwood <runderwood@pmaa.org>
Sent: Friday, April 9, 2010 4:07 PM
To: secretary <secretary@CFTC.gov>
Subject: Proposed Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations
Attach: PMAA Comments on Position Limits (RIN 3038-AC85).pdf

Mr. Stawick:

Please see attached PMAA's comments regarding the CFTC's proposed federal speculative position limits for referenced energy contracts.

Best Regards,

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April 9, 2010

David Stawick
Secretary
United States Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, D.C. 20581

Re: Federal Speculative Position Limits for
Referenced Energy Contracts and Associated Regulations

Dear Mr. Stawick:

The Petroleum Marketers Association of America (“PMAA”) is pleased to submit this letter to the Commodity Futures Trading Commission (“CFTC” or “Commission”) on its proposal to implement speculative position limits for futures and option contracts in certain energy commodities.¹ PMAA is a national federation of 47 state and regional trade associations representing over 8,000 independent petroleum marketing companies. These companies own 60,000 convenience store/gas stations and supply gasoline and diesel fuel to an additional 40,000 stores. Also, PMAA member companies sell, at retail, 90% of the heating oil consumed in the US. PMAA representatives have frequently testified before the Commission and before Congress on matters relating to the regulation of energy commodities and derivatives on energy commodities. We are grateful to have this chance to express our support for the Commission’s effort to establish speculative position limits for the energy markets and to provide our comments as to how they may be implemented in a sound, workable fashion.

Also joining PMAA in these comments is the New England Fuel Institute. NEFI is a member of the Petroleum Marketers Association of America, and an independent trade association representing the home heating industry since 1950. NEFI represents over 1,000 home heating oil and propane retailers and related service companies in New England and throughout the northeastern United states, most of which are small, multi-generational family owned- and operated-businesses. Many of these companies have been utilizing the futures markets for their hedging needs for decades in an attempt to protect customers from ever increasing uncertainty and volatility in energy commodity prices.

¹ *Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations*, 75 F.R. 4144 (Jan. 26, 2010) (“Release”).

PMAA has previously expressed the need for effective regulation of excessive amounts of speculative activity in the energy markets. In testimony before the CFTC in 2009, we outlined how the price of crude oil and energy products have become increasingly determined not by the forces of supply and demand, but by distortions in the market attributable to speculative trading by large-scale, institutional investors.² For example, in 2008, the price of crude oil rose from less than \$50 a barrel in January to over \$147 in July, and then dropped to just \$33 in December.³ That summer's record-setting prices for gasoline distressed the budgets of average Americans, curtailed travel and caused an overall drag on the economy as the costs of business overhead soared. In 2009, similar run-ups in prices occurred notwithstanding the sluggish state of the economy, high inventory levels, and steady supplies. This volatility was not due to supply and demand fundamentals. Rather, it appears to have been caused by excessively-leveraged speculators, index investors and hedge funds.

A. *The Commission's Proposed Energy Position Limits.*

In response to this unprecedented volatility in the energy markets, the Commission began a careful inquiry into the matter, including hearings held in the summer of 2009. Now, after a thoughtful, deliberative and open process, the Commission has advanced proposals to establish limits on positions that speculative traders may hold. The limits are proposed to apply across all accounts where a person has a 10% or greater equity ownership interest or controls trading, or where controlling parties are acting in concert. However, positions in a pool where a person is a limited partner, shareholder or similar would not have to be counted with that person's other positions so long as their ownership or equity interest in the pool does not equal or exceed 25%, and they do not control the pool's trading.⁴

1. *Aggregate Limits Outside the Spot-Month.*

For positions outside the spot month, proposed Rules 151.2(b) and (c) would prohibit holding net long or net short positions in "referenced energy contracts" in excess of defined limits. Referenced energy contracts would be any of four specified NYMEX contracts covering natural gas, crude oil, heating oil and gasoline and similar or linked contracts, including options, but would exclude basis contracts and diversified commodity index contracts. Limits applied across all reporting markets would be as follows:

- An aggregate all-month limit would be set at 10% of the open interest of the relevant contract aggregated across reporting markets up to 25,000 contracts, with a marginal increase of 2.5% of the aggregate open interest above that amount.

² See Testimony of Sean Cota, President, Cota & Cota, Inc., on behalf of the PMAA and the New England Fuel Institute (July 28, 2009).

³ See Margot Habiby, *Goldman, Morgan Stanley Threatened by CFTC Review (Update3)*, July 8 (Bloomberg) (available at <http://www.bloomberg.com/apps/news?pid=20601087&sid=aUH20H2Pqtr4>); Testimony of Sean Cota, *supra* n. 1.

⁴ Proposed Rule 151.4.

- An aggregate single-month limit would be set at two-thirds of the all-month limit described above.

As to positions on individual markets, limits would be established with respect to net long or net short positions in referenced energy contracts of the same “class” (*i.e.*, those with the same delivery method, whether cash or physical), as follows:

- An aggregate all-month limit would be set at the lesser of (i) the all-market / all-month position limit described above or (ii) 30% of the relevant exchange’s open interest value in such contracts, subject in either case to a minimum limit of 5,000 contracts or 1% of the aggregate open interest of such contracts across all reporting markets, whichever is greater.
- A single-month limit would be set at two-thirds of the single-market / all-month limit described above, provided that traders could not hold positions greater than two times the single-market / all-month limit on a gross basis.

2. *Spot Month Limits.*

In proposed Rule 151.2(a)(1) and (2), the Commission would prohibit holding net long or net short positions in contracts of the same class in excess of spot month position limits set at 25% of the estimated spot month deliverable supply.⁵ This standard would apply to both physically and cash-settled contracts. However, for contracts that settle in cash based on prices of physically delivered contracts, if permitted by rules of the reporting market, a trader could hold up to five times that amount if they do not hold positions in spot-month physically-delivered referenced energy contracts and file certain reports concerning their cash, futures, swap and other positions with the CFTC.⁶ For the purposes of this spot-month limit, contracts would only be deemed in the same “class” if they expire on the same trading day.⁷ Thus, traders could not net positions that expire on different trading days, resulting in a higher number of contracts that would count toward position limits.⁸

B. PMAA Supports the Adoption of Position Limits for Energy Contracts But Believes that the Commission Should Establish More Restrictive Limits.

PMAA strongly supports the Commission’s proposal to establish position limits for the referenced energy contracts. As we have previously noted, speculative position limits would serve to smooth out the volatility that can result from large amounts of funds moving into and out of market positions. Exchange-set position accountability rules have, in our view, been

⁵ The Commission would establish the estimated spot month deliverable supply based on estimates from the reporting markets, although it would be free to supply its own approximation. (Proposed Rule 151.2(d)(4).).

⁶ Proposed Rules 20, 151.2(a)(2).

⁷ Proposed Rule 151.1.

⁸ Release at 4159.

insufficient to control the excessive speculation that has buffeted the energy markets in recent years. For example, data released by Commission staff indicates that “in the 12 months between July 2008 and June 2009, accountability levels for individual months were exceeded in the four main energy contracts by 69 different traders, some exceeding the levels during every trading day in the period.”⁹

While we support the Commission’s effort to impose position limits on these markets, we believe that the position limit levels being proposed by the Commission are overly generous. As the Commission has noted, the proposed limits are “at the outer bounds of the largest positions held by market participants,” and standards for calculating positions are lenient. According to Commission staff, the proposed limits would only have affected ten energy traders across the four referenced energy contracts and some of those traders might have qualified for proposed exemptions. Further, omitting positions in certain pooled vehicles where a trader has a less than 25% interest would allow some parties, including sovereign wealth funds and other large investors, to skirt position limits by spreading energy-related investments among multiple pools over which they can still wield substantial influence. It is therefore unlikely that the proposed limits will meaningfully constrain the excessive speculation and undue market concentration that has plagued these markets. Thus, we urge the Commission to strengthen the proposal in three ways.

First, the Commission should revise the proposed limit levels downward to ensure fair and orderly markets and prevent a small handful of speculators from holding a controlling percentage of the open interest in any of these contracts. At the levels being proposed, PMAA is concerned that the position limits will have little, if any impact, on market concentration and will fail to achieve the important goals that the Commission has identified in promulgating the proposed rules. As an alternative, in accordance with the language of current regulation 150.5(c), we would support the Commission considering the customary historical position sizes held by speculative traders as a basis for establishing appropriate position limit levels. Considering the customary historical levels held by speculators (in the period prior to the run-up of energy prices) should result in limits that more effectively constrain a small number of traders from holding extraordinarily large speculative positions relative to total open positions. More restrictive position limits would help restore the balance that historically has existed between speculative traders and commercial users of these markets and help prevent price distortions that can result from unduly large speculative positions.¹⁰

Second, we believe the Commission should limit large, passive long positions, including those associated with commodity indexes. The greater part of the recent price spikes and

⁹ Release at 4169-4170.

¹⁰ Illustrative of these excessively high position limit levels is the limit for cash settled contracts that permits a trader to hold a position at five times the level of the cash-settled contract’s physically-delivered counterpart. Given the arbitrage relationship between the cash-settled contract and its physically-delivered counterpart, permitting a single trader in the spot month to hold a position in excess of the total deliverable supply on the physically-delivered contract creates the potential for significant price distortion.

volatility in energy markets came after 2004, when the SEC approved the first commodity-based exchange-traded funds.¹¹ In 2006, the SEC approved the first exchange-traded fund based exclusively on energy derivatives.¹² Such funds are exchange-traded, can be bought and sold through stock brokerage accounts, and have been marketed by the investment banks that create and manage them as a way to hedge against inflation. Their growth, and the growth of other passive long investment funds, caused a massive flow of money into the markets for energy and energy derivatives, which could not absorb such pressure.

Yet, the Commission's proposal would not directly address the distortive effects that such funds have on the market. Indeed, it would not even address a substantial portion of the trading that such funds engage in, because it would not count spread contracts or contracts on "diversified" indexes toward position limits. Moreover, the proposed definition of a "diversified" index (i.e., one with "price components that include energy as well as non-energy commodities")¹³ is so broad that a substantial number of the trades that have caused enormous volatility will not be covered by the rules. Worse, the Commission has effectively provided a safe harbor for three particular indexes, by specifically citing them as "diversified,"¹⁴ notwithstanding the fact that, measured by dollar weight, 71% of one such index consists of oil and gas products.¹⁵

PMAA believes that the influx of large index traders and other passive longs has had a deleterious effect on the orderly operation and price discovery function of the futures markets. While the regulated markets for the referenced energy contracts are deep and liquid, their ability to accommodate additional large volumes of trading without significant price distortion is not without limit. PMAA believes that index participants and other passive longs should not be permitted to grow to an unduly large percentage of the market. The Commission should either apportion market space among passive long participants or set lower position limits for index traders and other passive longs. Finally, all energy-related components of spread and index contracts, whether diversified or not, should be counted toward position limits.

Third, we believe it would be more appropriate to aggregate an entity's positions with those held in a pooled vehicle where that entity has an ownership level below the proposed 25% interest that is currently proposed. While current position limits for certain agricultural products apply a 25% standard,¹⁶ ownership levels far lower than 25% allow an entity to exercise substantial power over an investment vehicle. Given the energy markets' demonstrated

¹¹ See Letter re: *street TRACKS Gold Trust*, 2004 SEC No-Act. LEXIS 860 (Nov. 17, 2004).

¹² See Letter re: *United States Oil Fund*, 2006 SEC No-Act. LEXIS 422 (Apr. 10, 2006).

¹³ Proposed Rule 151.1

¹⁴ See Release, at 4153 n. 72.

¹⁵ S&P GSCI Commodity Index, *Components, Weights, Index Levels and Construction*, as of March 25, 2010 (available at <http://www2.goldmansachs.com/services/securities/products/sp-gsci-commodity-index/tables.html>).

¹⁶ 17 C.F.R. § 150.4(b); (c).

sensitivity to high levels of speculation and their importance to the economy as a whole, PMAA submits that it would be more appropriate to aggregate the positions of each non-commercial trader that invests in a pooled vehicle. Alternatively, a lower ownership threshold, perhaps 10%, would be an appropriate aggregation trigger.

On the other hand, we agree with the Commission that the proposed rules should not allow for the disaggregation of positions held by certain entities but which are controlled by “independent account controllers,” as is permitted under other position limits. *See* CFTC Rules 150.3(a)(4), 150.4. PMAA agrees with the Commission that that this disaggregation framework should not apply here. The proposed position limits are already set at high levels and as the Commission noted, traders could seek to exceed them through “establish[ment of] a series of positions, each near a proposed outer bound position limit, without aggregation.” Release at 4161. Moreover, to encourage fair and orderly markets, the Commission has a legitimate interest in limiting an entity’s speculative position whether its accounts are traded by one, or more than one, “independent account controllers” or whether it seeks to spread its position among different accounts or investment vehicles.

* * *

Once position limits are implemented, the Commission will have to periodically determine spot-month deliverable supplies pursuant to new Rule 151.2(d)(4), and to assess the efficacy of the new rules on an ongoing basis. Here, PMAA suggests that the Commission establish estimated spot month deliverable supplies not only after assessing estimates from reporting markets, but after independent consultation with governmental authorities and bodies with expertise in this area. In particular, we suggest that the Commission formalize its cooperative efforts with the Energy Information Administration (“EIA”) of the Department of Energy (“DOE”). The EIA is a statistical and analytical agency within DOE that independently collects and publishes energy-related information, including production figures, supply estimates and price data. Its reports are widely relied upon by commercial users, suppliers, marketers and traders. Therefore, we urge the Commission to independently assess and determine deliverable supplies and to base position limit determinations on the EIA’s data, as supplemented by information from reporting markets.¹⁷ We also suggest that the Commission enhance the role of the Energy Markets Advisory Committee by formalizing its membership and by charging it with the responsibility of presenting the views of its members as to the accuracy of estimates of deliverable supplies and the necessity of future revisions to position limits.

¹⁷ While we understand that reporting markets currently look to EIA reports when estimating deliverable supply, they are not required to do so, and a requirement to use this independent and transparent source would bolster market confidence.

C. PMAA Supports Aggregate Position Limits Across All Markets, Including OTC Derivatives and Foreign Boards of Trade.

PMAA believes that position limits in energy contracts should be applied on an aggregate basis across all markets offering similar contracts on the same commodity. Thus, aggregate position limits should be established covering contract markets, exempt commercial markets, OTC derivative markets and foreign boards of trade offering contracts in the United States linked to contracts offered on regulated markets in the United States. Aggregate speculative limits across markets would impose real limitations on large speculative positions that could not be easily evaded by trading similar or identical products in another market not subject to position limits.

PMAA supports proposed legislation being considered in Congress that would grant the Commission stand alone authority to regulate OTC derivatives. However, PMAA believes that the Commission already has ample authority to implement aggregate position limits across all markets -- and should do so in its current rulemaking. All market participants trading oil, natural gas, gasoline and heating oil on exchanges regulated by the Commission can, and should, be made subject to position limits that take into account their full trading position in the OTC derivatives market, on exempt commercial markets and on foreign boards of trade offering direct access to their contracts in the United States. A trader's participation in the regulated markets should be conditioned on compliance with aggregate position limits that take into account positions held in all markets.¹⁸ The Commission's statutory mandate to protect the price discovery function of its markets provides it with the power to establish position limits for contract markets and exempt commercial markets offering significant price discovery contracts as it deems necessary to reduce and prevent the burdens that come with excessive speculation -- a broad mandate that allows the Commission to take a trader's total positions in related contracts into account when establishing such limits.¹⁹ The Commission should exercise that authority in the current rulemaking.

D. Exemptions from Position Limits Must Be Narrowly Defined and Strictly Enforced.

PMAA recognizes that there is a need for narrowly crafted exemptions from position limit requirements for bona fide commercial hedgers. However, as history has indicated, when exemptions become too freely granted, the policies of deterring manipulation and preventing undue market concentration and excessive speculation that underlie the position limit proposal can be undermined. Thus, to promote confidence in the markets, we urge the Commission to

¹⁸ While it is probably difficult in the energy markets for traders to seek to evade limits by not trading on U.S.-regulated contract markets or exempt commercial markets at all, this situation could be dealt with by requiring as a condition to the risk management exemption for swaps dealers that dealers not enter into swaps with customers who have positions in excess of the aggregate limits. This rule could be policed through a robust reporting system directed to those dealers seeking a risk management exemption.

¹⁹ Commodity Exchange Act Sections 3, 4a(a), 7 U.S.C. 5, 6a(a).

narrowly tailor any exemptions to the position limit rules and to take sole responsibility for granting any exemptions for hedging purposes.

1. *Exemptions for Bona Fide Hedging.*

The proposed new rules would permit a trader to apply to the relevant exchange for an exemption from the position limits for bona fide hedging purposes.²⁰ A trader that received such an exemption and that holds a position outside the spot month, or that holds spot month positions would also be prohibited from holding or controlling speculative positions. If such a trader's positions equaled or exceeded twice the otherwise applicable limit, they could not also receive a swap-dealer risk management exemption (described below). In addition to applying to the relevant market for an exemption, such traders would also have to report certain data to the Commission, including information as to (i) their positions in the underlying commodity and its products and by-products; (ii) their interests in pooled investment vehicles that hold positions in referenced energy contracts, or the underlying commodity and its products and by-products; and (iii) their current and anticipated purchases and sales of the relevant commodity in the physical market.

PMAA supports the bona fide hedging exemption and believes that the Commission's proposal is a well-reasoned approach to allowing commercial users and suppliers of energy products to meet their hedging needs. The exemption would permit limits to be exceeded where there is a non-speculative purpose, and at the same time, limit the concentration of positions that would result if a large hedging entity also were to maintain speculative positions. However, the reporting markets are not well-suited to handle applications for exemptions. While exchanges have been allowed to grant exemptions from Commission rules, this practice appears to be a remnant of times when exchanges were less subject to competitive pressures and did not face the conflicts that may arise when their ownership and financial interests overlap with those of the financial institutions that trade on their platforms. In today's environment, especially as to a commodity where prices are such a public concern, and where the exchanges have publicly opposed position limits and questioned the value of the limits themselves, we believe that only the Commission has the requisite independence and singular focus on the public interest to grant exemptions from position limits.

2. *Exemption for Swap Dealer Risk Management.*

In the proposed rules, the Commission has created a special exemption for swap dealers that are hedging risks associated with their over-the-counter swaps business. The proposal would allow the Commission to grant exemptions for positions outside of the spot month that are held to offset risks associated with swaps that are entered into to accommodate swap customers. The exemption would allow dealers to hold up to twice the otherwise applicable position limits in all months-combined or in any single nonspot-month. In order to receive such an exemption, swap dealers must provide the Commission with information as to their overall trading positions

²⁰ Proposed Rule 151.3(a)(1).

and to keep books and records to substantiate the need for an exemption. Swap dealers holding risk management positions in excess of existing position limits would be barred from also holding speculative positions.

PMAA recognizes that swap dealers play an important role in energy derivative markets because they allow commercial entities to manage particularized risks through non-standardized OTC products. To facilitate this business, dealers should be permitted a limited exemption to manage the risks associated with these swap transactions with commercial hedgers. However the exemption should be narrowly tailored. Therefore, PMAA urges the Commission to take the “look through” approach described in the Release and by Commissioner O’Malia, whereby dealers would only receive exemptions from position limits for positions that offset risks that result from swaps with counterparties who would have themselves been entitled to a hedge exemption if they had hedged their risks directly in the futures markets. This “look through” exemption should be subject to an absolute cap of up to twice the otherwise applicable position limit. Such a rule would provide more than enough leeway for a dealer to manage its risks, while ensuring that position limits are exceeded only for the valid needs of commercial firms.

In any case, the Commission should retain the proposal to bar swap dealers holding such exemptions from also holding speculative positions. Allowing dealers to hold risk management positions in excess of the proposed limits as well as large speculative portfolios could result in unduly large and potentially disruptive positions and confer dangerous market power to a small number of market participants. In PMAA’s view, the energy markets do not suffer from a lack of speculative interest. Preventing swaps dealers (or commercial hedgers) from holding large speculative positions in the futures markets while also taking advantage of exemptions from position limits will not negatively impact the price-discovery and hedging functions of the marketplace.

E. PMAA Supports Greater Market Transparency.

PMAA commends the Commission for the additional reporting requirements reflected in the proposed rules. We believe, however, that the Commission should go further. The energy markets continue to suffer from a lack of adequate transparency, particularly as it relates to OTC derivatives trading. The Commission should extend its large trader reporting system to provide that large traders who are trading on regulated or exempt commercial markets whose combined exchange, OTC and FBOT positions exceed a specified level, file with the Commission large trader reports detailing their cash and derivatives positions. In addition, swaps dealers claiming a risk management exemption should be required to file reports containing detailed transactional data regarding their swaps trading and the energy positions of their major counterparties. These reports should extend beyond the summaries apparently contemplated by the proposed rule.

F. PMAA Supports Prompt Implementation of Position Limits.

PMAA strongly supports legislative efforts in Congress to reform our financial system and more effectively regulate our country’s derivatives markets. We support additional centralized clearing and exchange trading of standardized derivatives products and

comprehensive regulation of derivatives dealers and major market participants. As previously noted, we also strongly support additional transparency for the derivatives markets.

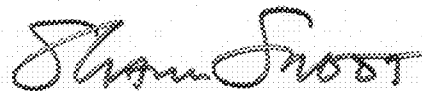
Nonetheless, we urge the Commission not to wait for the conclusion of an uncertain legislative process in order to move to improve the current regulatory regime applicable to energy trading. The Commission has a clear statutory mandate to ensure fair and orderly futures markets. The Commodity Exchange Act also clearly directs the Commission to set position limits to protect against the burdens of excessive speculation.²¹ In light of the tremendous harm that disruptions in energy markets caused to businesses and the U.S. economy in recent years, PMAA believes that the Commission should not delay implementation of the proposed new rules. The proposal to impose position limits reflects a sound conclusion after an open and transparent 6-month process in which the Commission received input from a wide range of market participants and interested members of the public. Given traders' familiarity with exchange-set position accountability rules and the Commission's extensive experience with position limits in other markets, there is little reason for a lengthy implementation period. Moreover, the proposal includes a grandfather clause for positions entered into in good faith before implementation of the rules. Therefore, we urge the Commission to move promptly to finalize and make effective meaningful position limits across all markets and improve reporting and market transparency generally.

PMAA supports the Commission's goal of protecting consumers and markets with sound policies that will foster open markets, fair competition, and transparent standards. The imposition of meaningful position limits will serve these goals by helping control excessive speculation while preventing undue market concentration. We appreciate the opportunity to comment on the proposed rules.

Sincerely,



Dan Gilligan
PMAA President



Shane Sweet
President & CEO of the NEFI

cc: The Honorable Gary Gensler, Chairman
The Honorable Michael V. Dunn, Commissioner
The Honorable Jill Sommers, Commissioner
The Honorable Bart Chilton, Commissioner
The Honorable Scott D. O'Malia, Commissioner

²¹ Commodity Exchange Act Section 4a(a), 7 U.S.C. 6a(a).