CME Group

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Managing Director
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August 15, 2011

VIA ELECTRONIC MAIL

David Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street NW
Washington, DC 20581

Re: Position Limits for Derivatives (RIN 3038–AD15 and 3038 AD16) (Federal Register Vol. 76, No.17, Page 4752)

Dear Mr. Stawick:

We are submitting the attached document as a supplemental comment letter on the Commission's notice of proposed rulemaking entitled "Position Limits for Derivatives" (the "Release"). The focus of this letter is the Commission's proposed expansion of conditional spot-month limits to all major physical commodities. We previously filed a supplemental letter with the Commission on August 5. Aspects of that letter were based on an incorrect data set; we apologize for our error and any inconvenience it has caused the Commission.[1] This supplemental letter serves as a replacement for our August 5 submission, addressing the issue cited above and offering some additional clarity where appropriate.

By way of background, spot-month position limits are a well-accepted regulatory tool employed by designated contract markets to avoid congestion, deter manipulation, and promote convergence of futures and cash markets. Spot-month limits for physical delivery contracts have long been set at 25% of the estimated deliverable supply of the underlying commodity as it is widely understood that 25% is the threshold at which a trader may be able to engage in price manipulation. In the Release, the Commission appears to recognize the importance of spot-month limits and the necessity for setting such limits at 25% of the estimated deliverable supply:

> Consistent with the Commission's longstanding policy regarding the appropriate level of spot month limits for physical delivery contracts, these position limits would be set at 25 percent of estimated deliverable supply. . . .

[1] Once we confirmed that the data set was erroneous, we notified the Commission and its staff. We also attempted to work with the Office of the Secretary to withdraw the August 5 letter from the Commission's web-site in order to avoid having anyone rely on the data. On Friday, August 12, we learned from Commission staff that the decision had been made by the staff to not allow for the withdrawal of the August 5 letter. To be clear, this letter reflects the corrected data and should supersede the August 5 letter which we ask the Commission to remove from its web-site now that this replacement submission is being filed.

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> The proposed deliverable supply formula narrowly targets the trading that may be most susceptible to, or likely to facilitate, price disruptions. The formula seeks to minimize the potential for corners and squeezes by facilitating the orderly liquidation of positions as the market approaches the end of trading and by restricting the swap positions which may be used to influence the price of referenced contracts that are executed centrally.

(Release at 4757.)

Contrary to both the longstanding joint policy of the Commission and the exchanges, the Commission proposes "conditional spot-month limits" for cash-settled contracts, which would permit speculators who never participate in or exit the physical delivery contract to hold five times the spot limit in a *cash-settled look-a-like product* during the final days of trading; these same speculators, however, also could hold up to 25% of the deliverable supply of the commodity and still hold five times the limit. *See* Proposed Rule 151.4(a)(2)(iii)[2]. While the exact scope of the Commission's conditional limits proposal is unclear, for purposes of this supplemental comment letter we primarily are concerned with cash-settled products that are directly linked to the physically-delivered contract subject to the spot-month limit.[3] For such linked contracts, any impact to physical supply is immediately translated to the physical contract settlement price by the laws of supply and demand, and necessarily to the settlement price of the cash-settled look-a-like given it is settled to the physically-delivered contract. Indeed, with respect to the natural gas market – the only market that has any experience with conditional limits – the Commission has observed that the cash-settled look-a-like contracts serve a price discovery function[4] and that "prices on the ICE and NYMEX contracts have an *ongoing, linked relationship* that extends not only to the linked settlement price but to prices between the two contracts throughout the trading day ."[5]

In the Release, the Commission recognizes that the purpose of position limits generally is deterring manipulation and excessive speculation and that the purpose of spot-month limits specifically is to target "trading that may be most susceptible to, or likely to facilitate, price disruptions." Apparently recognizing the tension between these policy objectives and its conditional limits proposal, the Commission attempts to justify its conditional limits proposal by stating that the proposal "maximizes the objectives [of the Commodity Exchange Act] of deterring manipulation and excessive speculation" and ensures "market liquidity and efficient price discovery by establishing a higher limit for-cash settled contracts as long as such positions are decoupled from large physical commodity holdings and the positions in physical delivery contracts which set or affect the value of cash-settled positions." (Release at 4758.) The Commission, however, offers no analysis in support of any aspect of the conditional limits proposal.

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[2] ICE misreads the Commission's proposal in this regard. In their response to our August 5 data submission, ICE says that the conditional limits are needed for hedgers. (ICE Response at 2.) On the contrary, the Commission expressly notes in the Release that this proposed rule is specifically intended for traders who do not have a hedge exemption. (Release at 4758.)

[3] This is not to say, however, that similar concerns would not present for cash-settled contracts that are economic equivalents to physical delivery contracts with Federal limits, but are not part of a linked market.

[4] *See* Jeffrey H. Harris, Commodity Futures Trading Commission, Chief Economist, Testimony at Hearing to Examine Trading on Regulated Exchanges and Exempt Commercial Markets (Sept. 18, 2007), comparing the price discovery function of the NYMEX physically-delivered Natural Gas futures contract to that of the ICE cash-settled Natural Gas contract.

[5] *See October 2007 "Report on the Oversight of Trading on Regulated Futures Exchanges and Exempt Commercial Markets* Order Finding That the ICE Henry Financial LD1 Fixed Price Contract Traded on the Intercontinental Exchange, Inc., Performs a Significant Price Discovery Function, 74 Fed. Reg. 37988, 37989-90 (July 30, 2009).

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As noted in our comment letter submitted on March 28, 2011[6], CME Group believes that adoption of the Commission's conditional limit proposal will increase the threat of price manipulation, especially in the final days of trading in the crucial spot month of all major agricultural, metals and energy futures contracts that call for physical delivery. The Commission should share this concern. Yet, the Commission's proposal would allow a speculator to maintain or establish a cash-settled futures or swap position equal to 125% of the commodity's deliverable supply in the final trading days of a physically delivered contract.

Moreover, the Commission's proposal both encourages a speculator to never participate in trading or to exit in the final trading days of the spot month the physically-settled futures contract, by allowing that speculator to hold five times the physical delivery contract limit and up to 25% of the physical commodity's total deliverable supply; that is, hold 25% of the physical commodity itself. Given that it is a longstanding regulatory principle that 25% is the threshold at which a trader may be able manipulate the market, the Commission's conditional limits proposal defies sound regulatory policy. Indeed, this concession to speculators must be seen as increasing rather than mitigating the risk of potential distortions as the Commission's conditional limits proposal increases the incentive to manipulate the less transparent physical market in order to benefit an outsized position in the cash-settled contract.

As previously noted, the conditional limits policy that the Commission proposes to apply to contracts on all covered physical commodities is currently in place *only* in the natural gas market. Although the Commission does have 17 months of experience with conditional spot-month limits in this one commodity, the Release neither contains an analysis of this experience nor explains why it is justifiable to expand the policy to other markets. Our attached submission contains, in part, some of CME Group's observations about that 17-month experience in the natural gas market based upon the limited (and corrected) data that is now available. These data show that, since conditional limits were introduced in February 2010, trading volume has decreased in the physically delivered natural gas futures contract (NG) in the critical 30-minute settlement period on the last trading day. In addition, when taking into account market volatility, the range in the settlement period in NG, on average, did not change materially since conditional limits were introduced; however, the two instances with the highest volatility adjusted closing ranges have occurred since conditional limits were introduced.

CME Group's opposition to the proposed conditional limits for all physical commodities (which would include agricultural, metals and other energy markets) is not based mainly on this data. Instead, the data illustrates how little we know about the impact of conditional limits on the all-important price discovery function of physically delivered commodity futures contracts.[7] Neither the Commission nor any commenter has explained how the limited experiment in conditional limits for natural gas justifies a major shift in regulatory policy applicable to all physical commodities – one that we believe will breed an increased risk of commodity price manipulation. We do not believe the Commission intends to increase the threat of commodity price manipulation, yet its proposal would do so.

The Commission also fails to explain why cash-settled contracts that are designed to be linked to the price discovery of a physically delivered contract should have a material, government-imposed, built-in advantage to attract liquidity through a disparate, five times higher speculative position limit. Favoring some markets to the detriment of others – particularly where those markets settle against and price off of the adversely impacted physical delivery market – is not a legitimate use of position limits nor is it an appropriate action for a regulatory agency. Based on the record, the only obvious motivation for conditional limits is favoritism of the cash-settled market for all physical commodities.

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[6] *See* CME Group Inc. Comment Letter on Position Limits for Derivatives dated March 28, 2011, available on the Commission's website.

[7] CME Group has submitted a FOIA request for any and all data considered or relied upon by the Commission in formulating its proposed conditional spot-month limits. That request was filed on July 20, 2011. CME Group has not yet received any confirmation about the status of its request.

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We appreciate the opportunity to submit the attached supplemental document on this important matter. We welcome any comments or questions regarding the data and views provided therein. Please feel free to contact me at (312) 930-3488 or Kathleen.Cronin@cmegroup.com, or Christal Lint, Director and Associate General Counsel at (312) 930-4527 or Christal.Lint@cmegroup.com.

Sincerely,

Kathleen M. Cronin

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I. Conditional Spot-Month Speculative Limit Proposal

Spot-month limits are well accepted as limitations to avoid congestion, avoid the circumstances that might invite an attempt to manipulate, and promote convergence of futures and cash markets. Conditional limits for the spot month must be judged based on their impact on those legitimate goals. The appropriate question is whether there is evidence that conditional limits, as have been proposed (or even as exist today), have furthered these legitimate goals. The Commission has previously found that physically-delivered contracts and their linked, cash-settled look-a-like contracts serve an integrated price-discovery function.[8] The Commission observed that the "prices on the ICE and NYMEX contracts have an *ongoing, linked relationship* that extends not only to the linked settlement price but to prices between the two contracts throughout the trading day."[9] Given the Commission's "one market" finding and the absence of any evidence in the record to the contrary, the Commission has no rational basis for its conditional limit proposal which would disfavor trading for physical delivery and favor trading that is cash-settled but linked to the physical delivery contract.

The data we discuss below does not support a new position limit regime that is structured to induce traders never to participate in or to exit the physically delivered futures market in favor of an identical cash settled contract. The data also does not support decoupling the physical delivery spot market contract from the forces of price discovery by precluding large speculators, who are taking advantage of the 5x limit, from arbitraging between the related contracts. Instead, our data shows that, since conditional limits favoring financial markets were implemented, volume in the NYMEX physically-delivered Natural Gas contract during the settlement period on the last trading day declined by 15.5%, and that when taking into account market volatility, the closing range in NG, on average, did not change materially; however, in two instances materially wider closing ranges were experienced after the introduction of conditional limits.

II. Volume and Price Analysis from Market Regulation

The table below shows various volume data before the conditional limit was initiated and after it had become effective. CME Group Market Regulation used the seventeen (17) expirations before the Conditional Limit became effective for the February 2010 expiration, as well as the seventeen (17) expirations after the conditional limit became effective.

Figure A: Volume Analysis for Natural Gas (September 2008 – June 2011)

Volume Analysis	Before Conditional Limit	After Conditional Limit	Change Since Instituting Conditional Limits	Percentage Change
Average Outright[10] Volume on Last Trade Day (LTD) Closing Range	8,187	6,919	-1,269	*-15.5%*
Average Volume on Option Expiration Day Closing Range	5,649	7,597	1,948	*34.5%*
Average Total Daily Volume[11] in spot month on last 3 trading days	51,912	56,027	4,115	*7.9%*

[8] *See* Jeffrey H. Harris, Commodity Futures Trading Commission, Chief Economist, Testimony at Hearing to Examine Trading on Regulated Exchanges and Exempt Commercial Markets (Sept. 18, 2007) (comparing the price discovery function of the NYMEX physically-delivered Natural Gas futures contract to that of the ICE cash-settled Natural Gas contract).

[9] *See* October 2007 "Report on the Oversight of Trading on Regulated Futures Exchanges and Exempt Commercial Markets," cited in Order Finding That the ICE Henry Financial LD1 Fixed Price Contract Traded on the Intercontinental Exchange, Inc., Performs a Significant Price Discovery Function, 74 Fed. Reg. 37988, 37989-90 (July 30, 2009).

[10] Only includes electronic outright transactions that are used for purposes of calculating settlement price.

[11] Includes all trade types.

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	Figure B: Price Analysis for Natural Gas (September 2008 – June 2011)				
	Price Analysis	**Before Conditional Limits**	**After Conditional Limits**	**Absolute Change Since Instituting Conditional Limits**	**% Change**
	Last Three Trading Days				
D	Average Price Range in Settlement Period for Last Three Trading Days	$0.054	$0.029	$-0.025	*-46.9%*
E	Average Price Range for entire day for Last Three Trading Days	$0.267	$0.152	$-0.115	*-43.0%*
F	Average Price Range in the Settlement Period as a % of the High Price for the Settlement Period for the Last Three Trading Days	*1.12%*	*0.69%*	*-0.43%*	
G	Average Price Range in the entire day as a % of the High Price in the entire day for the Last Three Trading Days	*5.31%*	*3.49%*	*-1.82%*	
	Last Trading Day				
H	Average Price Range in the Settlement Period on the Last Trading Day	$0.108	$0.059	$-0.049	*-45.3%*
I	Average Price Range in the Settlement Period as a % of the High Price for the Settlement Period for the Last Trading Day	*2.30%*	*1.43%*	*-0.87%*	
	Option Expiration (Penultimate) Day				
J	Average Price Range in the Settlement Period on the Option Expiration (Penultimate) Day	$0.025	$0.017	$-0.008	*-31.9%*
K	Average Price Range in the Settlement Period as a % of the High Price for the Settlement Period for the Option Expiration (Penultimate) Day	*0.49%*	*0.40%*	*-0.09%*	

Table Explanation:

Rows D, E, H, and J all seek to express the average difference in a particular price range utilizing a common methodology: Natural Gas futures are quoted as $.001 per MMBtu, where for example 0.054 would be 5 and 4/10 cents.

Row F is: (Closing Range High Price - Closing Range Low Price)
Closing Range High
Applied for the Last 3 Trading Days

Row G is: (Daily High Price - Daily Low Price)
Daily High Price
Applied for the Last 3 Trading Days

Row I is: (Closing Range High Price - Closing Range Low Price)
Closing Range High Price
Applied Exclusively to the Last Trading Day

Row K is: (Closing Range High Price - Closing Range Low Price)
Closing Range High Price
Applied Exclusively to the Option Expiration (Penultimate) Trading Day

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III. Volatility Analysis from CME Group Research and Product Development (RPD)

Based on data provided by Market Regulation, the RPD further examined whether there has been a measurable change in the volatility in NYMEX's physically-delivered natural gas futures contract since the introduction of conditional limits. We used 20-day historical volatility to normalize the closing range —creating a *Relative Closing Range* — and observed the 17 expirations that immediately preceded the introduction of conditional limits and the 17 expirations that immediately followed.

Key Takeaway:
The results of running multiple tests are consistent that when taking into account market volatility, the closing range in NG, on average, did not change materially; however, the incidence of wider closing ranges did increase after the introduction of conditional limits. Prior to the introduction of conditional limits, this *Relative Closing Range* spanned from 1% to 6% across all expirations except one where it reached 7.6%. After the introduction of conditional limits, the average *Relative Closing Range* decreased slightly (by 1/10th of a percent in absolute terms) although we observed two expirations exceeding 10%, which is well beyond what was experienced prior to the introduction. These observations are consistent with our concern that the closing range process is more susceptible to episodes of volatility as a consequence of the introduction of conditional limits.

Methodology:

- We evaluated the closing range for each termination day based on data from Market Regulation.
- We evaluated the 20-day standard deviation of settlement prices ("20-day STD") for each day, including termination days, for the expiring natural gas contract. This is a standard measure of realized market volatility. Our measure of standard deviation was in terms of the natural logarithm of price changes, a measure of percentage change in price. (We also completed the same analysis for outright price changes and there was no major change in any results.) Lastly, we conducted the analysis based on implied volatility.
- We compared the ratio of the closing range to the 20-day STD for the 17 expirations prior to the implementation of conditional limits to the ratio for the 17 expirations subsequent to the implementation. This ratio expresses the closing range relative to current market volatility; thus, it takes into account current market conditions. We refer to this ratio as the Relative Closing Range (RCR).

Summary of Results:

1. The average of the Last Trade Date RCRs before and after the implementation of conditional limits changed from .0398 to .0388 respectively.
2. In the second test, we modified the analysis to eliminate any potential "feedback" effect that could partially distort the results. To eliminate this bias, we used the 20-day STDs for the day immediately prior to the advent of the conditional limit period; in other words the 4th Business Day before the end of the month. We still used the expiration day closing range. This analysis using those 20-day STDs resulted in an average before-RCR of .0388 and an after-RCR of .0366. This demonstrated that there were no obvious distortions impacting the primary historical volatility analysis conducted on Last Trade Date.
3. In the third test, we modified the RCR by applying implied volatility (expressed in terms of dollars) instead of the STD. This, of course, substitutes a measure of market expectations for realized volatility. The results for this were that the before-RCR was .0313 and after-RCR was .0316, an increase of 1% after the conditional limits were introduced.
4. As noted above, we observed each individual expiry RCR. The September 2010 and November 2010 RCRs stood out in particular because they were much higher than any of the others. This reflects our concerns that the application of conditional limits can make an expiration more susceptible to volatility. Below, in Figure C, is a graph that depicts the monthly RCRs for each expiration in the volatility analysis.

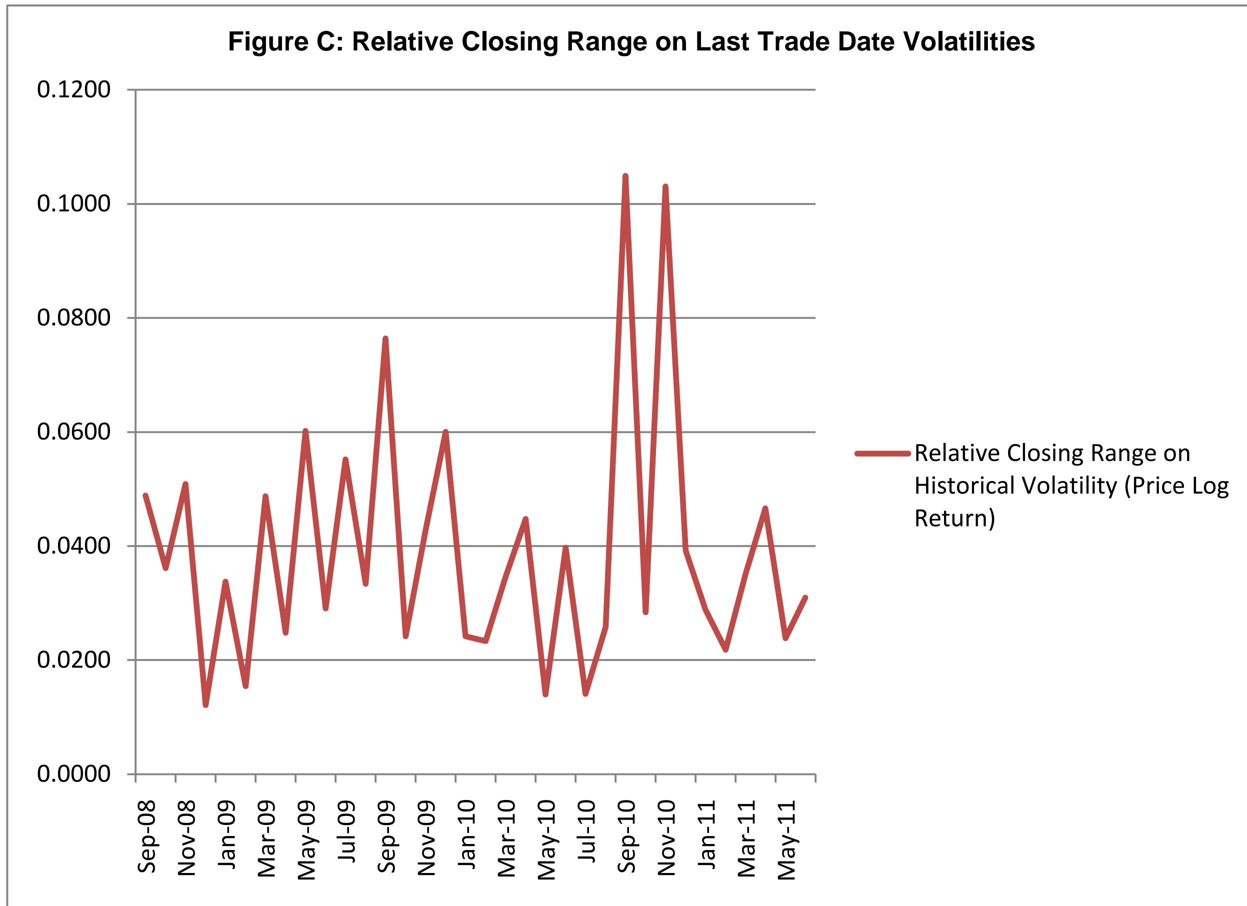
Figure C: Relative Closing Range on Last Trade Date Volatilities
0.1200
0.1000
0.0800
0.0600
0.0400
0.0200
0.0000
Sep-08
Nov-08
Jan-09
Mar-09
May-09
Jul-09
Sep-09
Nov-09
Jan-10
Mar-10
May-10
Jul-10
Sep-10
Nov-10
Jan-11
Mar-11
May-11
Relative Closing Range on Historical Volatility (Price Log Return)