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

VIA ELECTRONIC SUBMISSION

Re: *Spot-Month Position Limits - Conditional Exemption for Cash-Settled Contracts*

Dear Secretary Stawick:

On behalf of the Working Group of Commercial Energy Firms (the "Working Group"), Hunton & Williams LLP hereby submits this letter to reiterate its comments on the Commodity Futures Trading Commission's (the "CFTC" or the "Commission") Notice of Proposed Rulemaking on position limits issued pursuant to Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act").[1] Specifically, the Working Group submits this letter to restate important policy considerations and concerns regarding the proposed spot-month position limit and conditional exemption for cash-settled contracts as set forth in proposed CFTC Rule 151.4(a).

The Working Group understands that the Commission might be considering proposals to compress or eliminate the conditional exemption for cash-settled contracts as provided in proposed CFTC Rule 151.4(a)(2). For the reasons set forth in the Working Group comments addressing the *Position Limits Proposed Rule*,[2] and as restated herein below, it is imperative the Commission (i) carefully consider the impacts resulting from its proposed spot-month limits for cash-settled contracts, and (ii) reject any proposal to compress or eliminate such exemption. In light of the proposal to adopt aggregate limits across designated contract markets ("DCMs"), swap execution facilities ("SEFs"), and the bilateral over-the-counter ("OTC") market, the Working Group is especially concerned that the swap markets will be severely disrupted if the Commission adopts any proposal to compress the conditional exemption.

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1 *See* Position Limits for Derivatives, *Notice of Proposed Rulemaking*, 76 Fed. Reg. 4,752 (Jan. 26, 2011) ("*Position Limits Proposed Rule*").

2 *See* Working Group of Commercial Energy Firms, *Comments on Position Limits for Derivatives* (Mar. 28, 2011).

The Working Group is a diverse group of commercial firms in the energy industry whose primary business activity is the physical delivery of one or more energy commodities to others, including industrial, commercial, and residential consumers. Members of the Working Group are energy producers, marketers, and utilities. The Working Group considers and responds to requests for public comment regarding regulatory and legislative developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

A. THE WORKING GROUP RESPECTFULLY SUBMITS THAT THE PROPOSED SPOT-MONTH LIMIT FOR CASH-SETTLED CONTRACTS SHOULD BE SET AT A HIGHER LEVEL.

Proposed CFTC Rule 151.4 sets the spot-month position limit for cash-settled contracts at the same level as the level for physically-settled contracts, a level which is established as 25 percent of deliverable supply. As stated in its comments addressing the *Position Limits Proposed Rule*, and for the reasons set forth below, the Working Group believes the spot-month limit, if any, for cash-settled contracts should be set at a higher, more appropriate level.[3]

First, while the Working Group recognizes that the establishment of identical spot-month limits for cash- and physically-settled contracts has been the practice in recent years, it respectfully submits that the practice is not grounded in a sound regulatory foundation. Cash-settled contracts have substantially less potential impacts on pricing than physically-delivered contracts might have. Although deliverable supply is an important component for establishing position limits, if any, for physically-delivered contracts, its importance is greatly diminished with respect to cash-settled contracts.

Second, the Working Group submits that the approach in the *Position Limits Proposed Rule* inappropriately and substantially reduces current position limits on cash-settled referenced contracts.[4] Contrary to the policy goals of Commodity Exchange Act ("CEA") Section 4a(a), the *Position Limits Proposed Rule* will likely reduce market liquidity and disrupt the price discovery function of the underlying markets. Post Dodd-Frank Act position limits will also include swaps that previously were traded OTC and not subject to limits. As a result, the imposition of limits on cash-settled positions will be even more constraining, as

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[3] *See* Working Group Comments on *Position Limits Proposed Rule* at 20-22.

[4] For example, a NYMEX Henry Hub Natural Gas (NG) physically-settled futures contract has a spot-month limit of 1000. As a result, NYMEX (NN) cash-settled futures and an ICE HH LD1 swap each have a spot-month limit of 1000. By separating the spot-month limits into "physically-delivered" and cash-settled," and setting each spot-month limit at 1000, a market participant is effectively forced to add its NN position to its HH LD1 position, and whereas it previously could have held 1000 in each (2000 in total), it can now only hold 1000 cash-settled contracts in total.

positions previously excluded from a market participant's position will now be required to be included, while the levels will be reduced in some circumstances.

Accordingly, the Working Group respectfully requests that the Commission reconsider its spot-month position limit for cash-settled contracts and raise the limit to a significantly higher, more appropriate, level.

B. <u>THE PROPOSED CONDITIONAL EXEMPTION FOR CASH-SETTLED CONTRACTS SHOULD NOT BE COMPRESSED OR ELIMINATED</u>.

Proposed CFTC Rule 151.4(a)(2) provides for a conditional spot-month limit for cash-settled contracts. Specifically, a trader would be permitted to acquire positions that are five times the spot-month limit if such positions are exclusively in cash-settled contracts and the trader holds physical commodity positions that are less than or equal to 25 percent of the estimated deliverable supply of a physical commodity.[5] Further, to qualify for the conditional exemption, market participants may not hold any physically settled futures contracts.

Because the Working Group believes that the proposed spot-month limit for cash-settled contracts should be set at a higher level, it generally supports the conditional exemption for cash-settled contracts—notwithstanding the fact the Working Group believes the conditional exemption should be set at a higher level.[6] Higher limits for cash-settled contracts allow market participants to hedge more appropriately their final settlement price risk, and thus, any rule compressing or eliminating the conditional exemption would severely disrupt the practices of the entire market. Significantly, the Commission has already recognized the benefits of permitting a higher cash-settled limit, as it (i) currently allows such

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[5] Specifically, the conditional exemption for cash-settled contracts would apply if (i) such positions are exclusively in cash-settled contracts, and (ii) a trader holds physical commodity positions that are less than or equal to 25 percent of the estimated deliverable supply. With regard to the second condition, a trader may not hold or control (a) positions in cash-settled contracts in the spot month that exceed the level of any single month position limit, (b) any positions in the physical delivery referenced contract based on the same commodity that is in such contract's spot month, and (c) cash or forward positions in the referenced contract's spot month in an amount that is greater than one-quarter of the deliverable supply in the referenced contract's underlying commodity. *See* proposed CFTC Rule 151.4(a)(2).

[6] Further, the Working Group believes the condition requiring market participants to hold no physically settling futures contract is contrary to the statutory goals of CEA Section 4a to promote transparency, protect price discovery, and ensure the efficiency of markets. To the extent a hedger wants to avail itself of the conditional spot-month limit, it would be required to move out of physically settled futures, which would reduce liquidity and price discovery in the physically settled futures markets. The Working Group is concerned that the diminution in liquidity could negatively impact price convergence in the core physical delivery contract.

conditional limit in the cash-settled market[7] and (ii) reaffirmed the importance of such in its *Position Limits Proposed Rule*.[8]

Accordingly, as discussed in its comments on the *Position Limits Proposed Rule*, given the important policy and practical benefits that can be achieved through a higher spot-month limit for cash-settled contracts, the Working Group suggests an approach wherein cash-settled position limits are set as a multiple of physically-settled position limits, and so long as a market participant does not violate any position limit, its physical positions would not be limited in any manner.[9] To the extent the Commission declines this approach and adopts a conditional exemption for cash-settled contracts requiring market participants to hold no physically settled futures contracts, the Working Group recommends that the Commission decline any proposal to compress such exemption and, in fact, increase the proposed conditional exemption.

C. PROPOSALS TO COMPRESS THE CONDITIONAL EXEMPTION RAISE ADEQUATE NOTICE CONCERNS.

The Working Group believes that the adoption of regulations compressing the 5:1 conditional exemption in a final rule could be seen as a substantial deviation from, and not a "logical outgrowth" of, the *Position Limits Proposed Rule*. If the Commission were to adopt a regulation compressing the conditional exemption, then the Commission should issue a supplemental proposed rule that specifically addresses these concerns and provides for an additional comment period in order to provide market participants with adequate notice of such a significant change to the *Position Limits Proposed Rule*, as well as time to review and determine the practical, operational, and economical impacts of this change.

The Working Group recognizes that the Commission is in the deliberative process of formulating final rules regarding position limits and hopes that it will consider these supplemental comments. If you have any questions, please contact the undersigned.

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[7] The CFTC currently allows market participants in financially settled natural gas contracts (CME NN or ICE H) to take a position up to five times the position limit for physically settled natural gas contracts (CME NG) if the participant does not hold a position in the NG contract in the last three days of trading.

[8] The Commission declared in the *Position Limits Proposed Rule*: "The proposed limit maximizes the objectives, enumerated in section 4a(a)(3) of the Act, of deterring manipulation and excessive speculation while ensuring 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." *See Position Limits Proposed Rule* at 4758.

[9] *See* Working Group of Commercial Energy Firms, *Comments on Position Limits for Derivatives*, at 20-22 (Mar. 28, 2011).

Respectfully submitted,

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