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February 10, 2014

Ms. Melissa Jurgens, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581
Telefacsimile: (202) 418-5521 and
Email to secretary@cftc.gov and electronically to http://comments.cftc.gov

Re: Comments of the International Energy Credit Association to Commodity Futures Trading Commission ("CFTC" or "Commission") Notice of Proposed Rulemaking ("NOPR") respecting Position Limits for Derivatives, RIN 3038-AD99 pursuant to Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("DFA")

Dear Ms. Jurgens:

This letter responds to the Commission's request for public comment made by the above-referenced NOPR.

I. Introduction.

The International Energy Credit Association ("IECA") is an association of several hundred energy company credit management professionals, which has been grappling with credit-related issues in the energy industry for over ninety years. Our members' concerns regarding the DFA have led us to submit numerous comments, as well as no action requests, and petitions for delay and rulemaking to the Commission on its DFA rule-makings.

The IECA seeks to protect the rights and advance the interests of the commercial end user community that makes up its membership. IECA membership includes many small and large energy companies, few of whom are swap dealers, but all of whom have a fundamental mission of providing safe, reliable, and reasonably priced energy commodities that American businesses and consumers require for our economy and our livelihood.

The following comments lay out how the Commission's proposals in its NOPR have the potential to increase systemic risk, impair market function, and increase the costs and volatility of wholesale energy commodities. Since these costs will ultimately be passed on to businesses and consumers who are the ultimate end-users of energy commodities, these Commission

proposals, if implemented as final rules, will thereby have the potential to increase the costs of all goods and services in this country.

This letter will also explore how these new burdens that the Commission seeks to place on American businesses and consumers, many of which are only now beginning to recover from the 2008 economic crisis, are *sua sponte* Commission initiatives unrelated to any mandates placed upon the Commission by Congress.

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II. <u>Comments on the Proposed Rule</u>.

1. <u>Insufficiency of Findings to Impose Position Limits</u>.

In its NOPR, the Commission notes, "[f]rom the 1920s through 2009, a litany of official government investigations, hearings and reports document disruptive speculative behavior"[1] Yet, from such an apparently copious body of available evidence, the Commission cites for its evidence supporting position limits only two very unique examples within those ninety years. One of the examples, the Hunt brothers, is from 1979, a time when the prime rate of interest climbed from 12% to 20%,[2] and gold climbed from $233 to more than $845 per Troy ounce.[3] The general economic carnage of the time was not caused by silver speculation. The Hunt Brothers example concerned futures markets that at that time were regulated by the Commission, and not over the counter swaps markets. The other example is the recent Amaranth hedge fund operating heavily in futures markets as opposed to uncleared swaps markets. To be able to provide a mere two examples over the last 35 years, from the purportedly ninety years of evidence, creates an appearance of only limited, almost anecdotal, factual support for the broad imposition of position limits across diverse markets. This approach appears to be directly contrary to what members of Congress have specifically requested from the Commission.[4]

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[1] 78 F.R. 75759 col.1 (III.A.1 Background)
[2] between August 16, 1979 and April 2, 1980; data from St. Louis Federal Reserve Bank at http://research.stlouisfed.org/fred2/data/PRIME.txt
[3] Data from St. Louis Federal Reserve Bank at http://research.stlouisfed.org/fred2/graph/?s[1][id]=GOLDAMGBD228NLBM#
[4] See U.S. House, Committee on Agriculture, *Hearing to Review Implementation of Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act Relating to Position Limits* (Dec. 15, 2010) (statement from Congressman Jerry Moran to CFTC Chairman Gensler and Commissioner Chilton. "First, the Commission has never made an affirmative finding that position limits are appropriate to curtail excessive speculation. In fact, to date the only reports issued by the Commission or its staff failed to identify a connection between market trends and

In the NOPR, the Commission acknowledges that "studies show a lack of consensus regarding the … effectiveness of position limits",[5] but this does not "warrant[] erring on the side of caution"[6] to establish position limits as asserted by the Commission. This is because establishing position limits interferes with normal market function and is not an "err" on the side of caution, but rather an "err" on the side of disrupting normal market function and reallocating wealth by means other than markets. If position limits harm competition and harm the functioning of efficient markets, "erring on the side of caution" would be to NOT establish position limits. This is especially the case when other government studies conducted after the passage of DFA, such as one undertaken by the Congressional Budget Office, have found that position limits are harmful to markets.[7]

The IECA agrees with the statement in Section 4(a)(a)(1) of the Commodity Exchange Act ("CEA"), that:

> **Excessive speculation** in any commodity under contracts of sale of such commodity for future delivery made on or subject to the rules of contract markets or derivatives transaction execution facilities, or swaps that perform or affect a significant price discovery function with respect to registered entities causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity, **is an undue and unnecessary burden on interstate commerce in such commodity**.[8]

The IECA further agrees with the statement in Section 4(a)(a)(1) of the CEA that:

> **For the purpose of diminishing, eliminating, or preventing such burden**, the Commission shall, from time to time, after due notice and opportunity for hearing, by rule, regulation, or order, proclaim and fix such limits on the amounts of trading which may be done or positions which may be held by any person, including any group or class of traders, under contracts of sale of such commodity for future delivery on or subject to the rules of any contract market or derivatives transaction execution facility, or swaps traded on or subject to the rules of a designated contract market or a swap execution facility, or swaps not traded on or subject to the rules of a designated contract market or a swap execution facility that performs a significant price discovery function with respect to a registered

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excessive speculation. This is not to say that there is no connection, but it does say the Commission does not have enough information to draw an affirmative conclusion.").

[5] 78 F.R. 75695 col.3 (I.A.3 Necessity Finding)

[6] 78 F.R. 75695 col.3 (I.A.3 Necessity Finding)

[7] For example: "This analysis finds that less restrictive limits would generally have a greater chance of addressing observers' concerns, with fewer negative effects, than outright prohibitions would," is the conclusion of the Congressional Budget Office in its December 2010 report written to address the potential of Dodd-Frank Act position limits in emissions allowance derivative markets, "Evaluating Limits on Participation and Transactions in Markets for Emissions Allowances" available at http://www.cbo.gov/publication/21967.

[8] CEA §4(a)(a)(1).

entity, as the Commission finds are necessary to diminish, eliminate, or prevent such burden.[9]

However, as required by Section 4(a)(a)(2)(A), such position limits should ONLY be implemented "as appropriate" to diminish, eliminate or prevent excessive speculation. In accordance with 4(a)(a)(2)(A):

> **In accordance with the standards set forth in paragraph (1)** of this subsection and consistent with the good faith exception cited in subsection (b)(2), with respect to physical commodities other than excluded commodities as defined by the Commission, the Commission shall by rule, regulation, or order 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 contracts of sale for future delivery or with respect to options on the contracts or commodities traded on or subject to the rules of a designated contract market.

Accordingly, the IECA respectfully submits that pursuant to the CEA, the Commission should take the additional time to analyze and review each of the core referenced futures contracts to determine whether speculative position limits are necessary and, if adopted, will (i) prevent excessive speculation; (ii) deter manipulation; (iii) allow for sufficient market liquidity for hedgers; and (iv) permit price discovery.[10] It would "err" to do otherwise.

IECA's request that the Commission "err" on the side of caution and undertake the respectfully recommended analysis, as opposed to relying on two anecdotal events, primarily in futures and not swaps markets, that are nearly 35 years apart. Such a cautious regulatory approach would respect the important DFA Congressional intent to protect commercial end-users and is consistent with the DFA, the CEA and the Congressional intent behind the implementation of position limits. This is demonstrated by this exchange among Chairman Gensler, Commissioner Chilton, and Representative Neugebauer at the House Committee on Agriculture hearing[11] on December 15, 2010:

> **Mr. NEUGEBAUER.** Thank you, Mr. Chairman. Thank you for holding this hearing. **I think that the part of the Dodd-Frank that called for a finding—the question is the Exchange really—you all really haven't done anything in the sense of coming up with a specific finding. And so when you send the rule out, you are going to send a rule out that says we just think there needs to be limits out there. We don't have any finding that those limits are needed. Am I understanding that correctly?**
>
> **Mr. CHILTON.** Certainly Congress told us to put the limits in. We had the authority actually before this, but we didn't have support to do this. So we were instructed in the Dodd-Frank bill to put limits in. And the original purpose in the

[9] CEA §4(a)(a)(1).
[10] CEA §4(a)(a)(3).
[11] U.S. House, Committee on Agriculture. *Hearing to Review Implementation of Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act Relating to Position Limits* (Dec. 15, 2010) (emphasis added).

Commodity Exchange Act doesn't say that you have to jump some hurdle that proves beyond a shadow of a doubt in a court of law that speculators moved gas prices ten percent. The law says that we are to prevent and deter fraud, abuse, and manipulation; and so that is sort of the guiding onus that I look at, sir.

Mr. NEUGEBAUER. That is one of the things that we may have a disagreement on. **I don't necessarily know whether Congress told you to impose limits.**

Mr. CHILTON. Section 737.

Mr. NEUGEBAUER. If you look at it, it says, as the Commission finds as necessary to diminish, eliminate, or prevent such burden. **In other words, in what you have told this Committee today you don't have data that says that there are abuses or excessive speculation going on. I think the intent of Dodd-Frank was, if you find it, address it certainly.** I agree with the gentleman from Missouri. The job for government is transparency and integrity. But what we haven't heard today—and several of the people on the panel have asked this question. **We haven't heard you say we have identified where there is excessive speculation going on that could manipulate the pricing in the marketplace.**

Mr. CHILTON. Congressman, perhaps Congress should have put a finding in before we did it, but they didn't.

Mr. NEUGEBAUER. I know the story, and I agree with that. But since we didn't, **we kicked the ball to you and we said you should go out and address that issue and conduct an economic analysis.**

As noted by Representative Neugebauer, the CFTC has the ball and the IECA believes that the superficial findings listed in the NOPR are insufficient and do not cross the goal line for what Congress intended. In fact, they violate Congressional intent to protect market liquidity for hedgers.

As Judge Wilkins has said, "Congress has not ratified any CFTC interpretation of [CEA] §6a(a)(1) doing away with the necessity finding requirement."[12] For the CFTC to call DFA "increased statutory authority to … put the [Commission] 'back on the beat'"[13] rewrites history in commodity markets, where the Commission was never off the beat on commodities. DFA is primarily an introduction of the Commission to swaps markets; to the extent DFA provides the Commission new anti-manipulation authority in commodity markets, such new authority is not a resumption of an old "beat." When it added the "new beat" in the swaps market, that Congressional mandate came with an express instruction to protect the ability of commercial end-users to hedge or mitigate commercial risk.

[12] ISDA v. CFTC, [cite] Memorandum Opinion, p. 22 (2013).
[13] 78 F.R. 75759 col.3 fn.709 (III.A.1 Background)

The IECA wishes to make clear that it is not the IECA's position to encourage or protect entities or individuals that would attempt to corner the market in any commodity or to manipulate market prices. Instead, it is the IECA's position that energy companies and the economy at large, including consumers, benefit greatly from functioning commodity and commodity derivatives markets that provide sufficient liquidity for bona fide hedging of commercial risks.

The fact that the CFTC now has enhanced market manipulation enforcement authority under the CEA, as amended by the DFA, that is applicable to futures, options and swaps markets, and the fact that the CFTC is actively using that enforcement authority to investigate market manipulation allegations and extract financial settlements from the largest market participants, suggests that the CFTC's new enforcement authority will be deterrent enough to prevent excessive speculation and deter manipulation.

In fact, the IECA submits that the recent successes of the CFTC in its enforcement activities under this enhanced market manipulation enforcement authority should be sufficient to enable the CFTC to err on the side of caution and NOT impose position limits unless and until there is a sufficiency finding in order to avoid the potential unintended consequence of denying commercial hedgers in the markets sufficient market liquidity to hedge or mitigate commercial risks.

Moreover, if the CFTC's newly enhanced market manipulation enforcement authority is sufficient to accomplish the CFTC's "statutory direction to deter manipulation, while ensuring sufficient liquidity for bona fide hedgers without disrupting the price discovery process,"[14] then there is no justification for the CFTC to conduct experiments with the market especially when the results of those experiments with position limits have not been adequately studied or the success of such experiments documented.

The IECA respectfully submits that such experiments by the CFTC with insufficiently analyzed position limits are <u>not</u> "erring on the side of caution." In this regard, moving forward, without sufficient data to assess the potential impacts of the Commission's proposed rule, could leave the Commission without an adequate baseline for knowing if the position limits are helping or hurting the impacted markets.[15] The result of the CFTC's experiment of imposing unstudied and un-analyzed position limits could have an expensive unintended consequence of reducing liquidity in the market place to the level that bona fide hedging of commercial risks will no longer be a viable risk mitigation tool for energy companies and our economy.

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[14] 78 F.R. 75770 col 3 (III.A.4.i.c. Section 150.3(c) Conditional Spot Month Limit Exemption).

[15] See U.S. House, Committee on Agriculture. *Hearing to Review Implementation of Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act Relating to Position Limits* (Dec. 15, 2010) (statement from Congressman Michael Conaway to CFTC Chairman Gensler and Commissioner Chilton: "Not beating the lack of data dead horse to even further pulverize it, but if you go ahead and move forward without the data, as may be the indication that is here, how quickly will you know you have gotten it wrong? Are there things that you will watch for to say that we have driven speculators off that side of the deal and that burdens on hedgers have increased?... how quickly will you know that you have done some harm, rather than just trying to ease into this thing without disrupting it and creating—going crazy, as Mr. Chilton said? What are your matrix or your benchmarks to say this one was too far?")

2. Bona fide hedging.

a. Commercial End Users, and Therefore Those Consumers and Businesses That Purchase From Them, Are Put at Risk by the NOPR's Concepts.

CEA Section 4a(a)(2) discusses the imposition of "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 options on futures contracts with respect to physical commodities. CEA Section 4a(a)(5) expands the Commission's authority to "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 contracts of sale for future delivery or to options on the contracts or commodities traded on or subject to the rules of a designated contract market subject to [CEA Section 4a(a)(2)]." (Emphasis added.) In each instance, the CEA states, and Congress intended that, "bona fide hedge positions" are excluded from these position limits.

In this regard, the most salient feature of the two examples cited by the Commission in its justification for position limits may very well be the fact that the entities involved were professional speculators, and not commercial end users of the commodity, i.e., these entities were not "bona fide hedgers." Even the Commission acknowledges that "[l]imits do so by restricting the size of positions held by noncommercial entities that do not have hedging needs in the underlying physical markets."[16]

In fact, in the guidelines laid out by CEA Section 4a(a)(3) for the Commission to use in establishing position limits, one of those guidelines in CEA Section 4a(a)(3)(iii) is "to ensure sufficient market liquidity for bona fide hedgers."

As discussed above, the IECA is concerned by the absence of any significant analysis or studies of the CFTC's limits on speculative positions being proposed in this NOPR and, more specifically, the absence of any analysis of whether such limits on speculative positions will detrimentally impact the availability of sufficient market liquidity for bona fide hedgers.

The IECA is also concerned with the impact on commercial end-users in the energy industry, who routinely use many different types of swaps and derivatives as a means of hedging or mitigating the complex and dynamic commercial risks of their operations. The IECA is concerned that many of those commercial risk hedging transactions will not fit readily into the definition of "bona fide hedging" that the Commission has included in its position limits NOPR.

Moreover, the IECA is equally concerned with the absence of clear procedures and timelines by which commercial end-users will be able to obtain Commission approval of operations-critical "non-enumerated hedging exemptions."

[16] 78 F.R. at 75683.

This concern is magnified when you consider the statements of the Commission in the NOPR that:

> "To be clear, the statutory mandate in Dodd-Frank section 4a(a)(2) applies on its face to all physical commodity contracts. The Commission is nevertheless proposing, initially, to apply speculative position limits to referenced contracts that are based on 28 core referenced futures contracts listed in proposed §150.2(d). … Because the mandate applies to all physical commodity contracts, the Commission intends through supplemental rulemaking to establish limits for all other physical commodity contracts. Given limited Commission resources, it cannot do so in this initial rulemaking." (Emphasis added.)

In addition, exchanges are required to adopt and enforce speculative position limits for all contracts that are subject to Commission-set limits.[17]

On the basis of the foregoing, the IECA is concerned that all the physical commodities underlying the oil, natural gas, electricity and other energy commodity transactions utilized in its members' energy company businesses will eventually be subjected to similar broad and unworkable position limits rules, following the example proposed to be established by the Commission in this NOPR, which will leave an even larger number of legitimate commercial risk hedging transactions omitted from the Commission's definition of "bona fide hedging position."

b. The Commission Should Define "*Bona Fide* Hedging Position" Consistently with Existing Statutory Definitions and Industry Practices

i. The Commission Should clarify that Generally *Bona Fide* HedgesAre Not Limited to Hedges Enumerated in Section 150.1.

In the Commission's Vacated Final Rule on position limits, the Commission explicitly limited all *bona fide* hedges to a list of enumerated hedges by stating that *bona fide* hedges "mean any of the [enumerated hedges]." In the Commission's NOPR on position limits, the Commission states that *bona fide* hedges "include" the enumerated list of hedges. As noted below, the NOPR also states that *bona fide* hedges of physical commodities must be "enumerated in paragraph (3), (4) or (5) of this definition." The IECA recommends that the Commission explicitly state whether *bona fide* hedges are limited to an enumerated list of hedges.

ii. The Commission Should Not Restrict *Bona Fide* Hedges of Physical Commodities to Enumerated Hedging Transactions

The IECA agrees with the Commission that Section 4a(c)(2) of the CEA requires the Commission to require *bona fide* hedging transactions of physical commodities to include a

[17] Rule 1.61, 78 F.R. 75747 col. 2 at fn. 549.

temporary substitute test, an economically appropriate test and a change in value test. The Commission, however, interprets Section 4a(c)(2) to require a more restrictive exemption for *bona fide* hedges of physical commodities and limits such hedges to those enumerated in paragraphs (3), (4) and (5) of Section 150.1. The IECA believes that the Commission's interpretation lacks a statutory basis and ignores the Commission's broad exemptive authority under Section 4a(a)(7) and Congressional intent to preserve commercial end-users' ability to "hedge or mitigate commercial risk."

Though Section 4a(c)(2) adds an additional layer of requirements to hedges of physical commodities, Section 4a(c)(2) remains consistent with the broader current and historical definitions of *bona fide* hedging transactions throughout the CFTC regulations. In particular, CFTC Regulation Section 1.3(kkk) defines hedging as, *inter alia*, a position that is economically appropriate to reduce the risks of a potential change in the value of assets, liabilities, or services that the hedger reasonably anticipates providing, purchasing, selling or leasing, etc., in the ordinary course of business. In addition, notwithstanding Section 4a(c)(2)'s omission of the adverb "normally" to modify the verb "represents" with respect to the temporary substitution test, current Section 1.3(z)[18] contains similar language to Section 4a(c)(2)'s requirement of a temporary substitute test, an economically appropriate test and a change in value test. Yet, neither CFTC Regulation Section 1.3(kkk), current Section 1.3(z), nor Section 4a(c)(2) set forth any requirement that hedging transactions of physical commodities be limited to an enumerated list. The addition of Section 4a(c)(2)(B), on the other hand, specifically requires that the counterparty of a physical hedging transaction meet the requirements of the *bona fide* hedging transaction; there is no evidence, as the Commission suggests, that Section 4a(c)(2)(B) indicates a generalized legislative intent to restrict the hedging exemption for hedges of physical commodities. That would be inconsistent with protecting and preserving the ability of commercial end-users to hedge or mitigate market risks.[19]

Further, as the Commission acknowledges in the Proposed Rule, the Dodd-Frank Act, through its addition of Section 4a(a)(7), grants the Commission "plenary authority to grant general exemptive relief from the position limit rules." As a result, a plain reading of Section 4a(c)(2), when combined with the Commission's expansive exemptive authority under Section 4a(a)(7), indicates that Congress neither intended nor legislated that commercial risk hedging transactions of physical commodities be confined to an enumerated list of transactions. To the contrary, the Dodd-Frank Act's revisions to the CEA demonstrate a consistent conceptualization of a broader definition of *bona fide* hedge transactions of physical commodities.

A broad definition of *bona fide* hedge transactions of physical commodities will present a clearer regulatory regime for hedges and will better support the policy objectives underlying the

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[18] Current Section 1.3(z) provides a general definition of *bona fide* hedging transactions for those transactions or positions that "normally represent a substitute for transactions or positions to be made or positions to be taken at a later time in a physical marketing channel, and where economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, and where they arise from:

(i) The potential change in the value of assets which a person owns, produces, manufactures, processes, or merchandises or anticipates owning, producing, manufacturing, processing, or merchandising,

(ii) The potential change in the value of liabilities which a person owns or anticipates incurring, or

(iii) The potential change in the value of services which a person provides, purchases, or anticipated providing or purchasing." [emphasis added]

[19] See Letter of June 30, 2010, from Senators Christopher Dodd and Blanche Lincoln to Congressmen Barney Frank and Colin Peterson.

bona fide hedging exemption. The IECA agrees with the Commission that *bona fide* hedges reduce systemic risk by offsetting a hedger's recognized price risk. The IECA further agrees with the Commission that "because a firm that has hedged its price exposure is price neutral in its overall physical commodity position, the hedged entity should have little incentive to manipulate or engage in other abusive market practices to affect prices." Confining hedges of physical commodities to a limited list of enumerated transactions will prevent commercial end-users from engaging in risk-mitigating transactions that would otherwise pose little danger of manipulation or abuse. As a result, these end-users will either forego a transaction that would have reduced systemic risk or divert economic resources to foreign jurisdictions with less restrictive financial regulatory regimes.

Not only will the Proposed Rule's restrictive definition of a *bona fide* hedging transaction of physical commodities prevent end-users from hedging commercial risks of commodity-based businesses, but it may also deter hedgers from engaging in other hedging transactions. As noted, the Proposed Rule's restrictive definition conflicts with the broader definition promulgated throughout the Dodd Frank Act and CFTC Regulations. Such statutory inconsistency will create an uncertain regulatory regime; in particular, end-users may worry that the narrow definition of the Proposed Rule will subsume the broader definitions for swap dealers or end users in Section 1.3(kkk). Without certainty as to how the CFTC will classify certain transactions, therefore, end-users may be reticent to enter into commercial risk hedging transactions.

iii. The Commission Should Revise the "Economically Appropriate" Test to Permit Hedging by Profit Center, Line of Business, Regulatory Jurisdiction, or Other Group of Related Activities or Any Other Manner that Would Fit Within "Hedge or Mitigate Commercial Risk" 50.50(c).

The Dodd-Frank Act requires a *bona fide* hedge to be "economically appropriate for the reduction of risk in the conduct of a commercial enterprise." Under the Proposed Rule, an "enterprise generally should take into account all inventory or products that the enterprise owns or controls, or has contracted for purchase or sale at a fixed price." Though the term "enterprise" is not defined in the proposed rule, the Commission appears to have adopted a general requirement that market participants must hedge risks on an aggregate, enterprise-wide basis. Accordingly, hedges of specific risks in isolation would not generally be considered economically appropriate. The IECA agrees with the requirement promulgated by the Dodd-Frank Act and believes that the Commission's interpretation of the economically appropriate test is incompatible with the long-standing practices of commercial end-users.

In general, trading desks of commercial end-users typically manage their own trading positions, even as those trading positions are entered into for the benefit of the enterprise as a whole. An aggregated enterprise commercial risk hedging requirement, however, may preclude end-users from qualifying as a *bona fide* hedger because there will be aspects of the commercial enterprise that will have offsetting operational risks. For example, if a power company hedges its power purchases, but does not hedge its power sales, the hedge will not qualify for the exemption under the Proposed Rule because the transaction does not account for the natural "short" of sales to customers. The Commission's interpretation of the economically appropriate

test, therefore, will prohibit commercial end-users from engaging in transactions that, in practice, constitute an economically appropriate commercial risk hedge.

To improve the practicality of the economically appropriate test, the IECA recommends that the Commission define the term "enterprise" to permit hedging by profit center, line of business, regulatory jurisdiction or other group of related operations or commercial activities that comprise a subset of a particular legal entity or group of related legal entities. Such a definition would adapt the economically appropriate test to the portfolio of interest defined by a particular commercial market participant for the purposes of measuring and managing operational risk.

c. The Reporting Requirements for Anticipatory Hedges are Unnecessarily Burdensome

Under the Proposed Rule, aside from the monthly reporting requirement for general *bona fide* hedge positions, end-users engaging in an anticipatory hedge of an operational or commercial risk must also file initial, supplementary and annual reports under the Commission's position limits rules. The frequency and detail of the reporting requirements of anticipatory hedges will require end-users to adopt systematic reporting processes. The costs associated with such an operation will undermine the value of the commercial risk hedge and deter end-users from engaging in anticipatory hedges. Commercial end-users engaging in few anticipatory hedges may find that the costs of reporting outweigh the benefits of the hedges.

As an alternative to the proposed reporting requirements, the IECA proposes that the Commission modify the current duplicative reporting requirements by either (a) requiring an initial and annual report or (b) requiring an initial and supplementary report. The IECA recognizes that reports are integral in enabling the Commission to ensure that the *bona fide* hedge exemption is not abused. Accordingly, the IECA's proposal will reduce the burden on end-users while preserving the same level of information provided to the Commission under the Proposed Rule.

3. The "Orderly Trading Requirement" Increases Systemic Risk

The Commission's proposed "orderly trading requirement" presents a number of problems to the marketplace, especially to those who until now sought safety from markets to hedge their commercial risks. The proposed position limits rules would create significant new risks for entities seeking to hedge their exposures, and one of the most prominent examples of such new risks is in the "orderly trading requirement."

The "orderly trading requirement" is also a microcosm of a fundamental problem in many DFA regulations. Many DFA regulations, as well as Commission views towards swaps, seek to treat swaps as if they are futures. They are not. Swaps and physical positions simply are not exchange-traded futures, are not regulated by Congress as such under DFA, and cannot be successfully shoe-horned into a futures market *Weltanschauung*.[20] Many problems are created by proposed rules that incorrectly assume that physical positions behave similarly to contracts traded on futures exchanges. They do not; for example, physical positions cannot be subject to

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[20] Weinstein, *How the Dodd-Frank Act Will Bring Back Stagflation*, Futures & Derivatives Law Report, Jan. 2011.

automatic exchange stop losses sales and are not manageable by relying on reports of open interest. More to the point, Congress did not provide in DFA that swaps are to be treated the same way that the CEA treats futures.

The IECA believes that the NOPR's "orderly trading requirement" presents many risks to the end-user community and their respective markets, including, but not limited to, the risks enumerated below. These risks discussed below are further amplified by the proposed rules not applying merely to the 28 initial "core referenced futures contracts" currently listed by the Commission, because the Commission states it intends to expand the list of core referenced futures contracts to include all other physical commodities.

a. The Risk of Retroactive Loss of Bona Fide Hedge Status Could Lead Market Participants to Forego Commercial Risk Hedging Altogether.

The Commission's new "orderly trading requirement" applies not only to the entering of trades, but also to their maintenance and exiting. "The orderly trading requirement is intended to impose on bona fide hedgers a duty of ordinary care when entering, maintaining and exiting the market in the ordinary course of business and in order to avoid as practicable the potential for significant market impact in establishing, maintaining or liquidating a position in excess of position limitations."[21] This creates a new duty not to panic in a panicked market.

This would mean that the bona fide hedge is retroactively lost if the bona fide hedger entered the position in an orderly fashion, qualifying as a bona fide hedge at that time, but then later exited the position in a panic, or even if it maintained the position but was accused of negligent trading, negligent practices or negligent conduct. No one when entering into a trade can predict, nor should be accountable for, the conditions of the market when it exits. The market as a whole may be disorderly, rendering it impossible to exit in the "orderly" manner demanded by the Commission, giving the market participant the stark choice of further ruinous losses or enforcement action by the Commission.

There is also a feedback exacerbation risk- if the bona fide hedge is lost on a messy exit, the rest of the "position" may need to be dumped as exceeding the position limit, causing more disruption and potential liability and bona fide hedge disallowance.

b. The Commission's New "Duty of Care" for "Orderly Trading" Will Turn the Markets Over to the Courts.

The Commission proposes that a "position must be established and liquidated in an orderly manner in accordance with sound commercial practices";[22] and that the "orderly trading requirement is intended to impose on bona fide hedgers a duty of ordinary care when entering, maintaining and exiting the market in the ordinary course of business and in order to avoid as practicable the potential for significant market impact in establishing, maintaining or liquidating a position in excess of position limitations."[23] "The Commission believes that negligent trading,

[21] 78 F.R. 75707 col. 1 -2
[22] 78 F.R. 75707 col. 1.
[23] 78 F.R. 75707 col. 1-2.

practices, or conduct should be a sufficient basis for the Commission to disallow a bona fide hedge exemption."[24] The Commission goes on to say "in fulfilling their duty of ordinary care when entering, maintaining and exiting a position, market participants should assess market conditions and consider how their trading practices and conduct affect the orderly execution of transactions when establishing, maintaining or liquidating a position in excess of a speculative limit."[25]

"Negligence" is a word with significant legal meaning, just as "duty of care" is an element of the tort of negligence.[26] For the Commission to discuss "negligent trading practices" in its rules and imply a "duty of ordinary care" owed, perhaps to third parties in the marketplace, with respect to the "execution of transactions," seems to create a new private tort right of action that could be brought against a bona fide hedger by market participants whose positions lose value after a market exit by that bona fide hedger. After a day of market turmoil, those who lost money may turn to the courts as a way to recoup losses. Or perhaps shareholders would sue management. If there is tort liability for exiting trades in a disorderly fashion, companies might be remiss were they not to seek to make good their own losses after a market move by poring over the annual reports of competitors to sue those who closed significant positions on days of market turmoil.

These multiplied lawsuit risks will exacerbate market panic and fear. Ultimately, this will lead market participants and their management, who do not want to be sued, to eschew commercial risk hedging. Market participants should not risk liability to other market participants simply through a large trading exit. The current system of the market and accountability to shareholders already provides sufficient incentive for entities to not trade sloppily. Regulated cost of service utilities are further disciplined by their own public utility commissions, which will not allow them to recoup in cost of service losses from trading practices that the PUCs deem imprudent. FERC's requirement to conduct wholesale electric transactions at "just and reasonable" rates is a further disincentive for speculation. These protections, along with the Commission's investigatory authority, are sufficient oversight until the Commission has sufficient evidence that position limits are warranted.

c. Physical and Swaps Markets Are Different from Futures Markets.

The Commission is attributing to physical and swap markets the characteristics of futures markets. Futures market participant can place stop loss orders ahead of time, providing for a liquidation at a time when the market declines at a price. Physical and swaps markets have no such automatic mechanisms available. A human trader must pick up a phone or communicate with another party to sell or buy. If he has to make multiple phone calls over a period of time instead of closing the position as soon as possible, the trader's company is exposed to greater losses, while the market itself will always have hidden from it the true quantity of what is sought to be liquidated. Sometimes traders seeking to liquidate a large position will buy instead of selling and otherwise seek to prevent the market from learning of its distress, which should be a

[24] 78 F.R. 75707 col. 2.
[25] 78 F.R. 75707 col. 3.
[26] *Palsgraf v. Long Island RR. Co,* 248 N.Y. 339, 162 N.E. 99 (N.Y. 1928).

proper survivalist tactic, but doing so should be the business option of the trading entity, not a legal requirement that could give rise to liability if not successfully implemented.

If a market slide must be dribbled out by those seeking to liquidate being required to do so in dribs and drabs, the panic in the market will only be exacerbated and extended until the positions are closed. Another way in which the physical markets are not like futures markets is that a limit down for a futures contract cannot be set and trading halted in that contract until the market opens the next day. In the physical market, the slide will simply continue until the selling pressure is over. It does not enhance the transparency of markets to increase the time such selling pressure applies.

Another dramatic distinction between physical markets and the futures markets is the absence of an open interest indicator in physical markets. In futures markets, the published open interest number gives market participants some idea of what the market can bear when closing a position. There is no such indicator available in physical markets. The Commission's proposed inhibition of market function limits the ability to use markets to effectively hedge positions.

d. The Commission's "One Day" Liquidation Requirement Impairs Market Function.

"Once inventory has been sold, a person is permitted a commercially reasonable time period, as necessary to exit the market in an orderly manner, to liquidate a position in commodity derivative contracts in excess of a position limit. Generally, the [Commission] believes such time period would be less than one business day."[27] The Commission seems to be setting a time limit for a trade exit that hedges a commercial risk, while at the same time stating that the exit better not be disorderly due to market conditions on that day. Yet the Commission articulates no empirical basis whatsoever for its one business day requirements. The Commission also does not state why there should be one set time for all commodities, no matter how illiquid, and we know of no justification for this limitation. This could be more destructive of price discovery if the Commission requires a rush to one business day. A one-size fits-all-approach to all commodity markets and all commercial market risks is not appropriate; physical commodity markets are not futures markets. Therefore, the final rule should not implement a requirement or expectation regarding the one business day time period. .

A requirement of being "orderly" in putting on and off commercial risk hedges seems completely contrary to the Commission's stated mission of orderly and transparent markets. Rules that limit the size of what can be liquidated at any given time, with risks of enforcement from the Commission and liability to other market participants by causing the price to change, simply require parties to use markets in a way that hides the true volume that is to be liquidated.

The Commission's proposal also increases systemic risk, as liquidations to meet margin calls are delayed and the prices achieved from liquidation reduced as market participants must endure the risk of prices continuing to decline as they dribble out their positions, instead of liquidating them as soon as possible. Sales do in fact affect market prices and the markets should be permitted to reflect that; otherwise markets are obfuscating rather than transparent.

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[27] 78 F.R. 75713 col. 2

Securities and Exchange Commission rules concerning when a public announcement is required on Form 8k for Securities Act Section 12 reporting entities could also be affected by the Commission's proposed rule. A large inventory position so hedged may rise to a reportable event on a sale. Requiring a Section 12 reporting entity to exit positions in one day and do so in a manner that is "orderly," will simply create risk that will need to be weighed by companies against not hedging at all, thus increasing risk in the system overall.

4. Cross-Commodity Hedging

a. Substantially Related Test.

For when position limits are properly implemented as discussed herein, the IECA does not necessarily object to the Commission's proposed approach to cross-commodity hedging insofar as that approach says that the physical commodity underlying a commodity derivative contract (i.e., future, option or swap) proposed to be used to hedge against the risk of price movements in the cash market for a second physical commodity must be "substantially related" in order for the relevant commodity derivative contract to be a bona fide hedge. Creating a safe harbor for meeting the test for "substantially related" comprised of "qualitative factors" and "quantitative factors"[28] is similarly not conceptually objectionable. However, some of the statements in that portion of the NOPR are objectionable.

i. In Various Circumstances, Natural Gas and Electricity Prices Are Substantially Correlated.

In the NOPR (78 F.R. 75717), the Commission concludes "By way of example, the Commission believes that fluctuations in the value of electricity contracts typically will not be substantially related to fluctuations in value of natural gas." As support for that statement, the Commission includes quantitative data in Table 5 showing no real correlation between the Henry Hub spot and Henry Hub futures prices for natural gas and the prices for Houston electricity, PJM electricity and New England electricity. The IECA does not contest the data shown by the Commission in Table 5, but the IECA does object if that generalized conclusion is applied by the CFTC to prohibit a power plant owner from demonstrating that a commodity derivative contract based on the physical commodity of natural gas does satisfy the safe harbor for a substantially related cross-commodity hedge of that particular power plant's exposure to electricity price movements in the applicable cash market for electricity generated by that power plant.

In various electricity markets in the US, the next incremental generation unit called upon in a particular market will quite often be a natural gas-fired power plant. In that instance, the clearing price for such a regional power market into which a particular power plant, owned by entity X, sells its electricity is set by the price charged by a natural gas-fired power plant. If X's power plant is not fueled by natural gas, but is fueled by some other fuel (biodiesel for example), then X's ability to generate electricity at a price that will be competitive in that power market

[28] 78 F.R. 75716-75717.

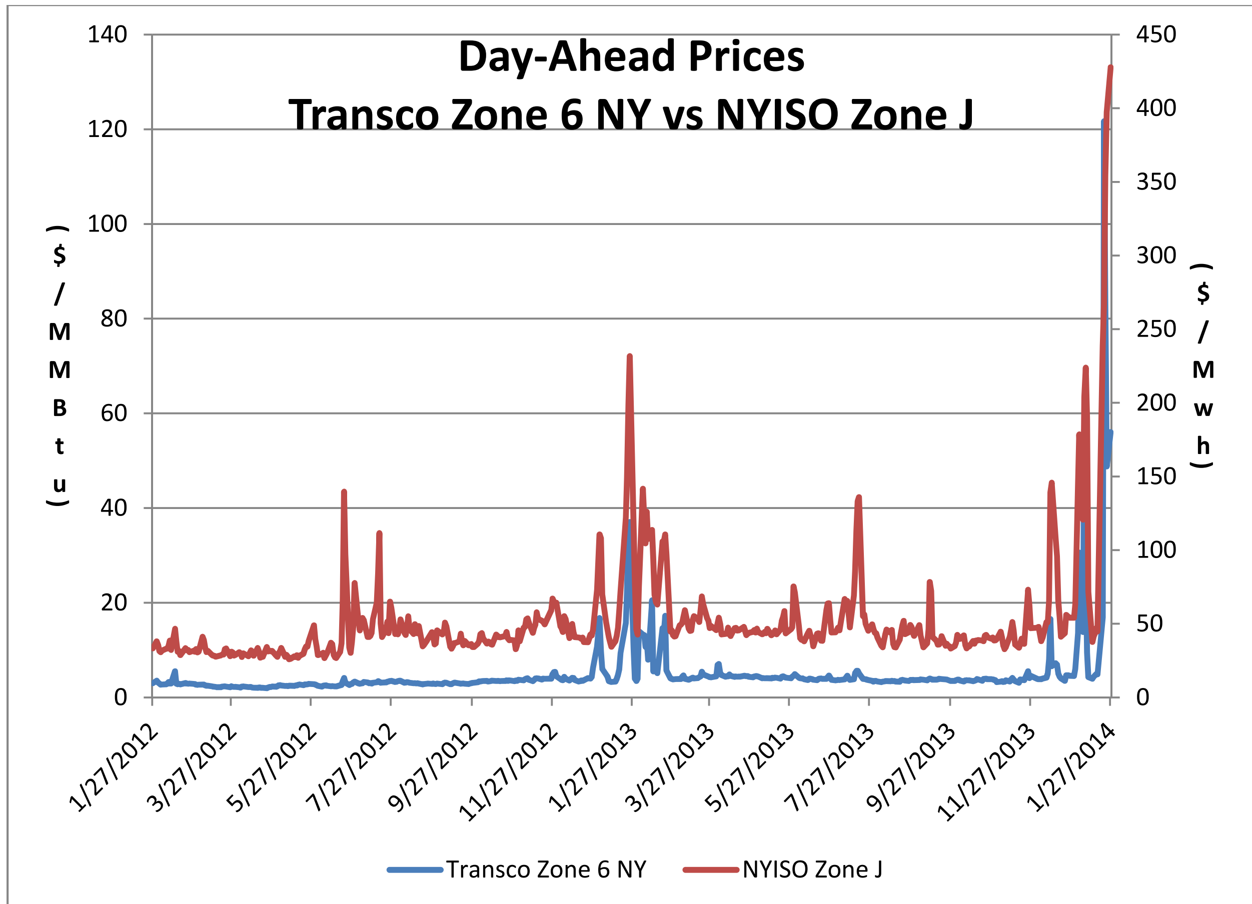
will need to be responsive to the price movements of the natural gas-fired power plant that sets the market clearing price. In that instance, X should not be precluded from demonstrating that its cross-commodity hedge based on natural gas prices is substantially related to the sales price available in the cash market place for electricity generated by X's power plant.

On this basis, the IECA strongly believes that under facts and circumstances that occur relatively frequently in the US power markets, natural gas hedge prices are substantially related to power prices and energy companies can reliably hedge or mitigate electricity price risk with a natural gas price commodity derivative contract.

A substantial relationship between the prices of natural gas and electricity has been long recognized by energy market participants as well as various energy regulators.[29] As the U.S. EIA report accurately illustrates, operators dispatch power plants based on their variable costs of generation, of which **a key input** is fuel costs.[30] Also, natural gas generators are often used to set the price of incremental costs of electricity and such pricing is used to set the prices for other generators as well. Natural gas fueled generation is one of the fastest growing sources of electricity.[31] Natural gas demand for power generation is rising and is expected to increase significantly in the coming years.[32] For example, natural gas fueled generation represents over 60% of the generation mix in CAISO.[33] It is simply unrealistic to create a presumption that the change in the price of natural gas would not have a substantial impact on price of electricity in CAISO. Further, the proliferation of various "heat rate" and "spark-spread" products used to hedge exposure of electricity buyers or sellers with natural gas price (multiplied by heat rate of a particular generation asset) illustrates that the price of electricity in various facts and circumstances is inextricably linked to the price of natural gas. Numerous electric utilities set their retail rates based upon, among other things, their ability to either hedge the cost of natural gas or pass the natural gas price increase onto their residential ratepayers. Recently, FERC concluded that "[r]eflecting the close relationship between natural gas and electricity prices, winter electricity peak futures prices in New England increased by 52% from last winter, to $100/MWh."[34] This further illustrates that the prices of natural gas and electricity in certain facts and circumstances are substantially correlated.

In fact, the IECA submits that many US electricity markets will show a substantial correlation between electricity prices and natural gas prices. For example, the following correlation of such prices in New York over the past two years.

[29] U.S. Energy Information Administration; "Cheaper natural gas alters generation dispatch in Southeast;" December 6, 2012, available at http://www.eia.gov/todayinenergy/detail.cfm?id=9090#.
[30] Id.
[31] U.S. Energy Information Administration; International Energy Outlook 2013; available at http://www.eia.gov/forecasts/ieo/more_highlights.cfm.
[32] FERC, Energy Primer, July 2012, p.7, available at http://www.ferc.gov/market-oversight/guide/energy-primer.pdf.
[33] Id, at 78.
[34] FERC, Winter 2013-14 Energy Market Assessment, p. 5, available at http://www.ferc.gov/market-oversight/reports-analyses/mkt-views/2013/10-17-13.pdf.



Electricity price hedges are simply not available in out years and natural gas is often the only alternative for a long-term hedge. Requiring energy companies to take out-year price risk, because the Commission does not think there is sufficient correlation is yet another example of the rules increasing risks and costs to consumers, and also one additional factor that the Commission does not take into account in its cost benefit analysis in the NOPR.

ii. <u>The Commission Incorrectly Applies Its Own Test in Testing the Correlation Between Natural Gas Prices and Electric Prices</u>.

A. <u>Qualitative Factors (pg. 75716 & 75717)</u>

The CFTC's stated marginal price in the spot market may be driven by something other than natural gas, therefore there is no substantial relationship as grounds for a cross-commodity hedge.

Due to decreasing natural gas prices , expanding pipelines and coal retirements this is becoming less truthful.

Gas does not have to be on the margin in an ISO to contribute to price. It is relative prices to alternatives that change system costs and drive what sets the electric locational marginal price (LMP) not outright prices of a single fuel.

The price series the CFTC uses is day-ahead price. Marginal resources in the day-ahead market are not limited to physical resources (virtuals, demand response, et al. can be marginal).

B. Quantitative Factors (pg. 75718)

The CFTC correlates day-ahead LMP for electricity at various ISO hubs with spot and futures Henry Hub natural gas prices. Prices at natural gas trading hubs geographically close to a given ISO are a more accurate reflection of the conditions in the spot market price for electricity in that ISO. Specifically, physical fixed price next day natural gas transactions, or the Gas Daily index, correlated against the day-ahead electricity prices are more reflective of conditions in the spot market for electricity. (For specific hubs, it may be helpful to look at what natural gas hubs Platts uses to calculate their implied heat rates daily for different ISO markets).

Comparing today's physical power price to any futures natural gas price makes little sense, because ISO obligations (bids and offers that form the LMP) only last a day or shorter.

Natural gas would be used only to hedge the risk in the energy component of the LMP for electricity, so its ability to do that should not be conflated with congestion and loss which are also factors in the LMP price for electricity (i.e., the total LMP).

The CFTC uses price returns and levels; alternatively a log of price returns is a more statistically accepted measure to evaluate electricity prices series.

iii. FERC Jurisdiction MOU

Many of the contracts that will be impacted by the NOPR are already regulated by the Federal Energy Regulatory Commission ("FERC") and therefore the additional oversight by the Commission should be implemented in a coordinated fashion with CFTC and FERC. Pursuant to the recent Memorandum of Understanding ("MOU") executed between the CFTC and FERC regarding potential overlapping jurisdictions, the IECA believes that notice to FERC is required pursuant to section II (A)(1). The IECA is encouraged by the CFTC's and FERC's ability to complete the MOU and look forward to your joint efforts in reviewing this requested clarification.

b. The "Dual" Objective and Subjective Requirement

i. A "Qualitative" Subjective Standard Should Be Subjective In the Mind of the Bona Fide Hedger

The Commission's proposed "non-exclusive safe harbor" of both qualitative and quantitative tests[35] should be replaced with a presumption permitting the entity hedging its unique commercial risks, rather than the Commission, to have a reasonable good faith basis to believe it can demonstrate a correlation between prices in support of any proposed cross-commodity hedging as a bona fide hedge. There should not be a requirement that the bona fide hedger prove a "reasonable commercial relationship" of any two commodities, as proposed to be required by the Commission, if it is already able to demonstrate an actual historical relationship through the "quantitative factor." Having already demonstrated a quantitative relationship, there can be no purpose of having to demonstrate externally any "qualitative" relationship that the fact of the relationship is "reasonable".

In the example shown in the NOPR concerning the alleged absence of any correlation between natural gas prices and electricity prices, the Commission used a statistical analysis (i.e., a quantitative factor), but no qualitative analysis, and then drew a conclusion which is totally unwarranted when viewed in the context of the facts and circumstances applicable to those in the electric generation industry in this country during the last 30 years.

If the statistical example set forth in the NOPR is used by the Commission to create a presumption that the safe harbor cannot be satisfied to demonstrate a substantial relationship between natural gas prices and electricity prices for purposes of a cross-commodity bona fide hedge, then the IECA must protest. As such, it appears to give the Commission the right to either ex post facto rulemaking, or the right to not have to provide an articulated rule and leaves the regulated entity with regulatory uncertainty. Such regulatory uncertainty will impact the industry's willingness to transact and thereby negatively impact market liquidity.

The electric industry is already seeing this impact as a result of the existing uncertainties around DFA-related compliance. It seems especially inappropriate to impose on commercial end users, who should by their desire to stay in business be assumed to be hedging their commercial risks in what they presume to be their best interests based on long exposure in the electric industry. Many regulated entities are already subject to a prudency review by State public utility commission regulators, who already examine, with in many cases decades of experience, the prudency of correlations for their hedging activities.

The IECA submits that the appropriate standard is found in Section 50.50(c). Even for banks, the exemption for "risk-mitigating hedging activities" included in the Volcker Rule would provide a useful paradigm that the Commission could consider incorporating into its final rule on position limits.

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[35] 78 F.R. 75716 col. 3

The Volcker Rule provides a multi-faceted approach to implementing the hedging exemption that seeks to ensure that hedging activity is designed to be risk-reducing in nature and not designed to mask prohibited proprietary trading. This multi-faceted approach is intended to permit hedging activities that are risk-mitigating and to limit potential abuse of the hedging exemption while not unduly constraining the important risk-management function that is served by a banking entity's hedging activities.

The Volcker Rule does not prescribe any specific hedging strategies that a banking entity must employ to avail itself of the exemption; rather, the rule requires banking entities to establish, implement, maintain and enforce an internal compliance program that is designed to ensure the banking entity limits its hedging activities to hedging that is risk-mitigating. Such compliance program must contain internal controls and ongoing monitoring, management, and authorization procedures, including relevant escalation procedures. Compliance program must provide for the conduct of analysis and independent testing designed to ensure that the positions, techniques, and strategies that may be used for hedging may reasonably be expected to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risks being hedged.

5. Trade Options Should Not Be Subject to the Position Limits Rule.

a. Trade Options are Commercial Transactions that are Properly Excluded from the Definition of Referenced Contract and Exempted from Position Limits

The IECA submits that commodity options that qualify for the trade option exemption under Section 32.3 of the Commission's regulations ("Trade Options"), just like forward contracts, are not intended to transfer price risk from one party to another, but are both simply commercial transactions intended to transfer physical delivery and ownership of a physical commodity from one party to another.

The plain language of the definition of "Trade Option" also provides a basis for the categorical exclusion of Trade Options from position limits. By its terms, Trade Options are commercial transactions" because at least one of the counterparties must be a commercial participant (a producer, processor, commercial user of, or merchant handling, the underlying physical commodity), and such commercial participant is offering or entering into the commodity option transaction solely for purposes related to its business as such. Since Trade Options are commercial and not speculative, it is unclear how subjecting Trade Options to position limits would further the Commission's efforts to "diminish, eliminate, or prevent excessive speculation." In fact, the Commission should exclude Trade Options from position limits to avoid imposing regulations that are designed to deter excessive speculation on transactions that are fundamentally commercial.

Moreover, including Trade Options within the position limits regime subjects them to a form of analysis that they simply do not fit. The NOPR defines a significant exclusion, arising from the statutory text, for "bona fide hedges." Although Trade Options are, by definition, commercial transactions, they may not meet the requirements for a bona fide hedging position.

For example, Trade Options that reference a floating price are designed, by their nature, to hedge supply risk and not price risk and therefore may not meet the "incidental test" or "change in value requirement" and therefore fail to qualify as bona fide hedging positions even though they consist of commercial transactions solely for purposes related to the businesses of the applicable commercial counterparties. Trade Options may also not be able to meet the "temporary substitute test," because it is unclear whether they would constitute a *substitute* for transactions or positions to be made or taken at a later time in a physical marketing channel or the *actual* transaction or position in the physical marketing channel itself.

The requisite intent for physical delivery of a physical commodity upon exercise under the definition of "Trade Option" provides another basis for the categorical exclusion of Trade Options from position limits. Although the requirements for forward contracts and Trade Options are phrased differently, in many respect Trade Options are functionally similar to forward contracts, when analyzed in relation to excessive speculation and other applicable contexts. Both forward contracts and Trade Options are commercial transactions. Where forward contracts are executed between commercial participants, Trade Options are executed by one or more commercial participants. Moreover, the circumstance where an offeror of a Trade Option is an eligible contract participant, but not a commercial participant, should not change the analysis. Just as confirmation by a commercial participant that it is entering into a swap for purposes of hedging and not speculation can confer pass-through swap status for the benefit of its counterparty, so too should qualification of a transaction as a Trade Option, by virtue of its definitional requirement that at least one counterparty is a commercial participant entering into a Trade Option solely for purposes related to its business, definitively exclude such Trade Option from position limits for the other counterparty. Context matters, and the Commission should take the fundamental commercial nature of Trade Options into account in its deliberations on position limits.

Trade Options are, by definition, commercial transactions, and therefore any attempt to include them within position limits will create confusing questions of interpretation under the regulations and impose significant burdens on commercial participants for compliance with no benefit of preventing excessive speculation. Although Trade Options are swaps as a legal matter, when viewed in context, there is a sound basis for the Commission to conclude that Trade Options should be excluded from the position limits rule.

Therefore the IECA fully supports excluding Trade Options from the definition of "referenced contracts" and, therefore, exempting Trade Options from the Commission's proposed position limits.

In fact, the IECA submits that commercial participants enter into commodity derivative contracts in order to hedge against the cash market risks of price volatility of the physical commodities that commercial participants intend to purchase or sell pursuant to one or more Trade Options. In this regard, the commercial participants treat their Trade Options as the basis of a bona fide hedging position, just as they treat their forward contracts as the basis of a bona fide hedging position. As such, the IECA notes that these commercial participants in the energy industry would not expect to be able to "net" their Trade Options against any commodity derivative contracts that offset the risk of their Trade Options any more than those commercial

participants would expect to be able to net their forward contracts against any commodity derivative contracts that offset the risk of their forward contracts.

Moreover, except for some fraudulent activity or misunderstanding of the regulations (which the CFTC could pursue under its CEA enforcement authority) by a commercial participant, the above treatment of Trade Options would not permit commodity options that should be regulated as swaps to circumvent the protections established in the Dodd-Frank Act for the forward contract exclusion for non-financial commodities.

Although the Commission's exemptive relief in Section 32.3 of the Commission's regulations for Trade Options does not extend to the position limit requirements, the Commission requested in the NOPR, "whether it would be appropriate to exclude trade options from the definition of referenced contracts and, thus, to exempt trade options from the proposed position limits." In this regard, the IECA strongly believes that there is no stated or apparent benefit to the Commission that would justify the tremendous burden this proposed position limits rule will create for the IECA's members if the proposed position limits rule includes Trade Options.

b. **Trade Options are Not "Swaps" Within the Plain Meaning of DFA and Therefore Should Not be Subject to DFA Position Limits Rules**

If the Commission declines to follow the IECA's recommended regulatory treatment in 5.a above, then the IECA offers the following comments regarding the application of the proposed position limits rule to Trade Options.

According to the Commission's regulation on Trade Options, §32.3, certain DFA requirements applicable to swaps will nevertheless be applicable to commodity options that are "intended to be physically settled…." The Commission in its own Rule 32.3(a)(3) requires a Trade Option to be a "The commodity option must be intended to be physically settled, so that, if exercised, the option would result in the sale of an exempt or agricultural commodity for immediate or deferred shipment or delivery." However, this directly conflicts with Congress's own wording in the DFA, which specifically excludes from the definition of swap "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled." Including Trade Options within position limits is contrary to the plain language of DFA. It is absolutely clear that Congress did not intend for Trade Options to be regulated as swaps.

In its Commodity Option Interim Final Rule, the Commission provides "an exemption from certain swaps regulations for trade options on exempt and agricultural (nonfinancial) commodities as between commercial and sophisticated counterparties."[36] The Commission said that "the final rule issued herein adopts the Commission's proposal to generally permit market participants to trade commodity options, which are statutorily defined as swaps, subject to the same rules applicable to every other swap. The interim final rule adopted herein includes a trade option exemption for physically delivered commodity options purchased by commercial users of

[36] See 77 Fed. Reg. 25326.

the commodities underlying the options, subject to certain conditions."[37] The Commission bases its Commodity Option rule on DFA §721, which added new §1a(47) to the CEA, defining "swap" to include not only "any agreement, contract or transaction commonly known as," among other things "a commodity swap," but also "an option of any kind that is for the purchase or sale, or based on the value, of 1 or more … commodities."[38]

The Commission's interpretation of CEA §1a(47) as including all options on physical commodities contains a fundamentally flawed statutory interpretation. The Commission ruled that all commodity options are swaps,[39] by reading only §1a(47)(A) and ignoring §1a(47)(B)(ii). CEA §1a(47)(A) defines the new statutory term "swap," and begins with the phrase: "Except as provided in subparagraph [CEA §1a(47)](B)…". CEA 1a(47)(A) then goes on to include in the statutorily defined term 'swap,' in CEA 1a(47)(A)(i), "any agreement, contract or transaction that is a put, call, cap, floor, collar or similar option of any kind that is for the purchase or sale … of 1 or more … commodities … ." Section 1a(47)(B) takes precedence over all of §1a(47)(A). CEA §1a47(B) begins with the phrase "The term "swap" does not include….and then CEA §1a47(B)(ii) provides "any sale of a nonfinancial commodity … for deferred shipment or delivery, so long as the transaction is intended to be physically settled … ." (emphasis supplied). Although the Commission characterizes CEA 1a(47)(B)(ii) as a forward contract exclusion, it is an "intended to be physically settled" exclusion with no mention of options or optionality.

In its Commodity Options Rule the Commission took the CEA's exclusion from all of DFA of transactions that are intended to be physically settled and made it an element of being subject to some of DFA. Under CEA §1a(47)(B)(ii) "The term 'swap' does not include any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled". Yet, the Commission in this instance defines "physically settled" as "if exercised, the option would result in the sale of an exempt or agricultural commodity (i.e. non-financial) commodity for immediate (spot) or deferred (forward) shipment or delivery", and adds an element requiring intent of "both parties".[40] Yet "settled" does not mean "purchased" or "sold" or "delivered", and the above phrase added by the Commission to §1a(47)(B)(ii) at 77 F.R. 25326 col. 3 is not in the statute at all. Something that can only be physically settled must be intended to be physically settled, whether or not one or both parties "intend" to "purchase" or "sell" or "deliver". The Commission has added two new elements - "dual intent" to "actually deliver" that are not in the statute.

The statute clearly provides that if the parties to a deferred shipment or delivery transaction for a nonfinancial commodity intend to physically "settle" (not "deliver"), then CEA section §1a(47)(B)(ii) trumps CEA §1a(47)(A)(i) and the Commission was not given jurisdiction over such commodity options as "swaps." The Commission has plenary jurisdiction over such commodity options pursuant to CEA §4c and provisions of the CEA pre-dating DFA, but not as "swaps" pursuant to DFA.

Accordingly, an option for deferred shipment or delivery of a nonfinancial commodity

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[37] See 77 Fed. Reg. 25321.
[38] Id.
[39] 77 F.R. 48236-37
[40] 77 F.R. 25326

that is intended to be physically settled (a "Trade Option") cannot be a swap under CEA §§1a(47)(B)(ii) and 1a(47)(A)(i). Therefore, such an instrument should not be a "swap" subject to position limits.

This is consistent with Congress's intent: nonfinancial commodity transactions (even options) are not exchanges of cash flows, nor did they have or present any risk of deleterious effect on the economy or contribute to the 2008 financial crisis. DFA was not intended to give the Commission new jurisdiction over the broad "real economy" world of nonfinancial commodities.

c. **Including Trade Options Within Position Limits Rules Violates Due Process**

The manner in which the Commission has included Trade Options within position limits runs afoul of due process of law. The Commission published its proposed Commodity Option rules on January 13, 2012,[41] before anyone could have known they needed to comment on the rules because the Commission would dramatically expand its jurisdiction to forward, physically settled transactions with embedded physical optionality in its Further Definition of "Swap" rulemaking published August 13, 2012.

In Footnote 6 of its Commodity Options rule, the Commission says that it "uses the term 'commodity options' to apply solely to commodity options not excluded from the swap definition set forth in CEA section 1a(47)(A), 7 U.S.C. 1a(47)(A)."[42] The Commission then describes the pending final rule defining a "swap," which is being developed jointly with the SEC, and says: "The final rule and interpretations that result from the Product Definitions NPRM will address the determination of whether a commodity option or a transaction with optionality is subject to the swap definition in the first instance. If a commodity option or a transaction with optionality is excluded from the scope of the swap definition, as further defined by the Commission and the SEC, the final rule and/or interim final rule adopted herein are not applicable."[43] This means that no one had the ability to comment on the Trade Option rule with any inkling that transactions that are intended to be physically settled would be regulated by the Commission as swaps under DFA and that the Commission would make them subject to position limits rules by interpreting "physically settled", which is an exclusion from DFA under §1a47(B)(ii), as instead an element of a trade option that would require inclusion within DFA and some DFA compliance.

Had the Commission allowed market participants to comment on its rules before promulgating them it would have obtained useful information. For example, the Commission would have learned that it is impossible to comply with the position limits rules for trade options embedded in many types of forward contracts with volumetric optionality that have now been captured by the CFTC as swaps subject to position limits.

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[41] 77 F.R. 2136
[42] 77 F.R. 25321; note that the Commission does not refer to CEA 1a(47)(B)(ii).
[43] See 77 Fed. Reg. 25321.

6. **The Commission's Proposed Utility Hedging Rules Are at Odds with How State Regulation Works**

"The proposed new exemption would recognize a bona fide hedge position where a utility is required or encouraged to hedge by its public utility commission."[44]

This is not how utility regulation works. PUCs "allow" prudently incurred costs to be recovered. PUCs generally don't "require" or "encourage" hedging; rather, they may allow it, and they may also after-the-fact disallow recovery of hedging costs or losses because of a failure to hedge when that hedge would have been prudent. PUCs "encourage" entities they regulate to be prudent. PUCs generally don't "encourage" before the fact hedging; rather they punish for lack of prudency after the fact. It would not be typical for a regulated entity to be able to produce to the Commission an order from a state PUC that states that the entity is "required" or "encouraged" to hedge. The burden of proof to show "require" or "encourage" will generally not be met by regulated entities under current state PUC regulatory models. These models are unlikely to be changed at the behest of Commission rules.

At a minimum, this should read "is not prohibited from hedging" rather than "required or encouraged to hedge." Regulators will not prohibit hedging (may permit or allow) when there is a reasonable belief that such activity will reduce risk for the utility's customers- and this can be applied before or after the fact. Regulated utilities have no incentive to engage in speculation: should they lose money on speculating, the loss will be suffered by shareholders; should they make money on speculating, the gains could well be passed on by their state regulators to ratepayers, and certainly all gains above the allowed rate of return will be passed on to ratepayers. A utility unable to economically serve ratepayers would not speculate to make up the "loss," rather, it would obtain a rate increase from state regulators.

The Commission should not condition its proposed bona fide hedge exemption for unfilled anticipated requirements for resale by a utility on instances in which a utility is *"required or encouraged to hedge by its public utilities commission."* Public utility commissions generally do not require or encourage hedging by natural gas utilities; ex ante approval of specific hedging programs or strategies is not the norm. Public utility commissions ultimately determine whether to allow or disallow gains or losses from hedging activity to be passed through to customers through rates; ex post prudency review is the norm. Municipal utilities and public gas agencies and electric cooperatives are generally not subject to oversight from state public utility commissions with regard to rates; therefore, such entities would not be eligible for the proposed exemption conditioned upon a requirement that they be required or encouraged to hedge by their public utility commissions.

Therefore, proposed section 150.1(3)(iii)(B) of the proposed rule should be revised as follows:

> *(B) Long positions in commodity derivative contracts that do not exceed in quantity unfilled and/or unpriced anticipated requirements of the same cash*

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[44] 78 F.R. 75713 col. 3

commodity for resale by a utility ~~that is required or encouraged to hedge by its public utility commission on behalf of~~ to its customers~~' anticipated use~~.

[or alternatively:

(B) Long positions in commodity derivative contracts that do not exceed in quantity unfilled and/or unpriced anticipated requirements of the same cash commodity for resale by a utility that is permitted to ~~required or encouraged to~~ hedge by its public utility commission on behalf of its customers~~' anticipated use~~.]

7. Incomprehensible/Unreasonable "Economically Appropriate" Rules

a. The Commission's "Enterprise" Test is Unworkable

While it is reasonable for the Commission to expect that bona fide hedge positions be "economically appropriate for the reduction of risk in the conduct of a commercial enterprise," the Commission is proposing the unworkable interpretation that "[i]n order for a position to be economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, the enterprise generally should take into account all inventory or products that the enterprise owns or controls, or has contracted for purchase or sale at a fixed price."[45] This requires market participants to hedge risks on an aggregate, enterprise-wide basis, which would mean the hedges of specific risks in isolation of the enterprise as a whole would not generally be considered "economically appropriate" under the NOPR.

For example, an electric utility should be able to hedge fuel supply on a plant by plant basis, and should not be required to consider fuel purchases by other plants, or be required to move a new "long" position in gas that develops in a plant with a forced outage to an operating plant before hedging the operating plant's short position in natural gas. There could be pipeline and other transmission constraints between the plants, and as a general principle, being required to hedge across plants to a fleet that may be a portfolio of wind, gas, coal, solar, and nuclear would be so fundamentally complicated and unworkable as to require utilities to eschew hedging altogether, to the determine of ratepayers.

This is particularly important in respect of energy companies regulated by FERC Standards of Conduct for Transmission Providers,[46] which requires the independent functioning of regulated businesses, and prevent the sharing of certain types of information between a company's regulated and non-regulated businesses. With limitations on information sharing, it is unclear how a regulated entity could verify whether a natural hedge or offsetting position is present in another business unit. A total enterprise hedging requirement could effectively precondition, and therefore effectively prohibit, bona fide hedging on certain types of inappropriate information sharing.

Trading desks at commercial enterprises like energy companies typically manage their

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[45] 78 F.R. 75709 col. 3.
[46] 73 FR 63829, October 27, 2008.

own trading positions, even as those trading positions are entered into for the benefit of protecting the enterprise as a whole from identified market risks. But when those traders in taking trading positions must be cognizant of every implied position of the enterprise as a whole, they will not be able to function effectively or rationally. Under the proposed rules, trading desks would not be able to hedge their positions as bona fide hedges if other parts of the company have natural positions the other direction. A company with a fleet of vehicles is a natural short in gasoline, if the fleet's natural short in gasoline must be considered by the company's trading desk in considering whether to hedge the trading desks' long position in gasoline, the trading desk will never be able to effectively hedge its discrete long gasoline position, resulting in volatility and more systemic risk overall as companies forego the very substantial benefits of engaging in matched hedges of positions.

The "total enterprise hedging" requirement will likely mean that no one will qualify to be a bona fide hedger, because there will be aspects of the enterprise that will have an offsetting risk. For example, if a power company hedges its power purchases but does not hedge its power sales, it seems that its trading desk hedges will not count as bona fide hedging because it does not account for the natural "short" of the sale to customers. Or is the hedge position supposed to not set off just the hedge of the floating price purchase risk, but also account for the fixed price sale risk in order to qualify as bona fide hedging?

Regardless of how the term "enterprise" is defined, the Commission should acknowledge that there are numerous circumstances in which it may be economically appropriate for a commercial enterprise to hedge specific risks in isolation, rather than in aggregate. Any hedging activity designed to reduce or otherwise significantly mitigate and demonstrably reduces or otherwise significantly mitigates one or more specific, identifiable risks, arising in connection with and related to identified individual or aggregated positions, contracts, or other holdings, based upon the facts and circumstances of the individual or aggregated underlying and hedging positions, contracts, or other holdings, should be considered "economically appropriate." Should the Commission insist that a commercial enterprise hedge risks on an aggregate basis, market participants should be given latitude to define the term "enterprise" in a manner that permits hedging by profit center, line of business, regulatory jurisdiction or other group of related activities that comprise a subset of a particular legal entity or group of related legal entities. The term "enterprise" should be defined in such a manner that the term means nothing more than the portfolio of interest defined by a particular market participant for purposes of measuring and managing risk.

b. "Price" v. "Value"

In the NOPR, the Commission says, "For example, processing by a soybean crush operation or a fuel blending operation may add relatively little value to the price of the input commodity. In such circumstances, it would be economically appropriate for the processor to offset the price risks of both the unfilled anticipated requirement for the input commodity and the unsold anticipated production; such a hedge would, for example, fully lock in the value of soybean crush processing."[47]

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[47] 78 F.R. 75709 col. 1-2

Either the Commission is using "price" to mean the same thing as "value," or it is not. If it is, then the Commission should just use the one word, "price." If it is not, then the Commission should not involve itself in distinguishing between "price" and "value." Such a distinction could end up meaning many different things; for example seeking to distinguish "accounting profit and loss" from "economic profit and loss." The value to a commercial end-user hedging or mitigating commercial risk is more than price. Regulators should not be looking at a price/value distinction, but rather the transactions.

Price is not "potential change in value." It is price change that is the "risk" that can be hedged. Whether the hedging entity can pass on the price increase to customers is not "hedging value" or an effective substitute for hedging change in price risk. The Commission should clarify that "potential change in value" includes potential change in cost to purchase, or revenue from sale of, commodity in ordinary course of commercial enterprise's cash operations.

In one confusing sentence in the NOPR, the Commission says "a manufacturer may anticipate using a commodity that it does not own as an input to its manufacturing process however, the manufacturer expects to change output prices to offset substantially a change in price of the input commodity."[48] Is the ability to pass on price changes to customers relevant? If so, why? And what is the impact to compliance if not, or the ability to pass on costs changes due to market forces?

For hedging service contracts, the NOPR permits a person to hold short or long positions in commodity derivative contracts, which are offset by the anticipated change in value of receipts or payments due or expected to be due under an executed contract for services as long as such contract arises out of the production, manufacturing, processing, use, or transportation of the commodity underlying the commodity derivative contract. To this requirement the IECA recommends adding "or pricing on such contract is directly or indirectly linked to the price of the commodity underlying the commodity derivative contract." For example, this would cover a coal transportation contract that is partially indexed to the price of diesel fuel or certain chemicals contracts partially indexed to the price of natural gas.

8. <u>Unpriced Contracts</u>

"An appropriate hedge of unfilled anticipated requirements would be to establish a long position in a commodity derivative contract to offset the risk of such unfilled anticipated requirements."[49] This does not match the risk of unfilled requirements. A purchase option at a fixed price, or even a purchase contract at a fixed price hedged with a derivative sale of the physical long might also be (more) appropriate. "Unfilled" should also mean "unpriced" to the extent that a party enters into index priced agreements to acquire the anticipated requirements but uses derivatives to effectively fix the price.

The Commission should clarify that its proposed bona fide hedge exemptions related to unfilled anticipated requirements and unsold anticipated production would also apply to

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[48] 78 F.R. 75709 col. 1
[49] 78 F.R. 75713 col. 3

circumstances in which a market participant has filled its anticipated requirements, or sold its anticipated production, with index-priced contracts, whereby such anticipated requirements or production, while not "unfilled" or "unsold," respectively, remain unpriced and therefore remain exposed to price risk.

Section 150.1(3)(iii)(A) of the proposed rule should be revised as follows:

(A) Long positions in commodity derivative contracts that do not exceed in quantity unfilled and/or unpriced anticipated requirements of the same cash commodity, and that do not exceed twelve months for an agricultural commodity, for processing, manufacturing, or use by the same person; and

Section 150.1(4)(i) of the proposed rule should be revised as follows:

(i) Hedges of unsold and/or unpriced anticipated production. Short positions in commodity derivative contracts that do not exceed in quantity unsold and/or unpriced anticipated production of the same commodity, and that do not exceed twelve months of production for an agricultural commodity, by the same person.

9. Process for Applying for a non-enumerated Hedge

Risks presented by exchanges being required to adopt and enforce speculative position limits for all contracts not subject to Commission-set limits. (Rule 1.61, p. 238 at fn. 548). This is very concerning if new bona fide hedge definition now applies to all exchange limits. Some of the existing limits on electricity contracts are incredibly small.

The Commission should provide for a clearly defined process for timely review and action on requests from market participants seeking non-enumerated hedging exemptions. The Commission should adopt, as suggested, an administrative procedure that would allow the Commission to add additional enumerated bona fide hedges without requiring notice and comment rulemaking.

10. Pass-Through Swaps and Qualification as Bona Fide Hedging Position

The Commission fails to account for the considerable burden that its exemption for pass-through swaps will impose on end users not otherwise subject to position limits. Although the Commission has suggested that entities whose aggregate positions do not approach the size of an applicable position limit could avoid costly swap-by-swap compliance procedures (such as implementing real-time monitoring software) by assigning internal limits or other similar steps, this ignores the fact in the case of pass-through swaps, the regulations virtually require swap-by-swap compliance. Section 150.3(g)(2) requires that a party may utilize the pass-through swap exception only if its counterparty represents in writing at the time of the swap that it is "a bona fide hedging position." Therefore, unless an end user elects to not provide such representation when asked by its counterparty and face the potential that it will be charged a higher price for such swap, § 150.3 will *require* that end user to provide its counterparty with a specific, contemporaneous written representation for each particular pass-through swap. That party will

also be required to maintain all books and records relevant to that representation. Thus, any market participant dealing with counterparties who utilize the pass-through exemption would bear the cost of developing systems to provide that representation. Under the proposed rule, this burden is considerable.

The Commission should address this various ways. First, the Commission could greatly narrow the magnitude of the concern by revising and clarifying its treatment of "enterprise." The burdens of addressing hedging on a "total enterprise" basis – discussed above – are challenging for even the most sophisticated entities, but become unduly difficult for end users otherwise far from the specified position limit thresholds. Those entities, which the Commission appears to assume could avoid swap-by-swap compliance, would in fact be required to assess each pass-through-swap request individually with reference to unrelated activities in other divisions and affiliates. Permitting end users to hedge their risk on a gross basis (as well as a net basis where appropriate) would reduce the burden. Second, the Commission should also review all of its other proposed regulations relating to bona fide hedges and modify and/or reduce the requirements, where appropriate, in light the potential burdens imposed on end users whose aggregate positions do not approach the size of an applicable position limit.

11. Conditional Spot Month Limit

Since February 2010, the Commission has provided for a "Conditional Limit" for financially settled natural gas futures contracts during the last three days of contract trading. Under the Conditional Limit, a market participant may carry a position in the financially-settled natural gas futures contracts (ICE H or NYMEX NN) that is up to 5 times that of the physically settled natural gas futures contract's (NYMEX NG) position limit if the participant agrees not to hold a position in the NG futures contract in the last three days. The Commission codified the "Conditional Limit" in its 2011 proposed rulemaking on position limits, and stated: "[t]he proposed limit maximizes the objectives, enumerated in CEA§4a(a)(3), 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."

The NOPR reaffirms the Conditional Limit policy and recognizes that many market participants need to pay or receive the final settlement price of the NG or Referenced Contract to perfect their hedges, which is most effectively accomplished by holding cleared or bilateral swaps to expiration. Removing or reducing the Conditional Limit would disrupt present market practice. Furthermore, eliminating or decreasing the Conditional Limit for cash-settled futures contracts would be a significant departure from current rules, which have the support of the broader market. The NOPR itself will already effectively halve the present Conditional Limit by converting it to an aggregate limit across designated contract markets, swap execution facilities, and the bilateral OTC market. Further constraining this limit would reduce even further the ability of hedgers to cost-effectively take swaps to final settlement as necessary to perfect their hedges.

Moreover, the Conditional Limit is in addition to market participant's bona fide hedge exemptions and is crucial for providing liquidity to the cash market in the spot month. The Conditional Limit is necessary to maintain liquidity in an already constrained market. Even if a market participant is unable to avail itself of the Conditional Limit, this exemption is critical for liquidity providers. Furthermore, as the Commission has indicated in the proposed rule, the CFTC intends to add additional energy contracts to the definition of Referenced Contracts and maintaining the Conditional Limit will be imperative going forward. For the reasons noted above, the Commission should adopt final rules maintaining the status quo and maintaining the Conditional Limit at its current level.

12. Guaranties

The IECA fully supports the Commission's proposal excluding guaranties from the definition of "a referenced contract."[50]

III. Conclusion.

The IECA appreciates the opportunity to provide the foregoing comments and information to the Commission. This letter represents a submission of the IECA, and does not necessarily represent the opinion of any particular member. If you would like for us to expand our discussion of any of the above-listed discussion points, please let us know.

Yours truly,
INTERNATIONAL ENERGY CREDIT ASSOCIATION

/s/	/s/
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[50] 78 F.R. 75701 col. 1